

NIBM Convocation Address

Kaushik Basu

Dr Subbarao, Dr Saha, members of the faculty, students, graduating students, their parents, and other guests. I am really honoured and have great pleasure being with you here today in Pune. Your Institute has been growing in stature over the years, so you should be really proud. I am saying this to the students that they should really be proud graduating from here. I have great pleasure coming to Pune which is one of the leading cultural centres of India and, also while I do enjoy being in Delhi immensely, I live on an adrenalin rush, especially when you are an economic advisor in Delhi. When you get away occasionally you realize the value of the adrenaline rush dropping. I really feel that and I want to thank once again Dr Subbarao and Dr Saha, for inviting me to be here with you today.

I thought that I would take advantage of being away from Delhi and from, in fact, the big cities where so much of economic policy making is driven by headline news. Being in an academic institution, an academic setting gives one the opportunity to do a little bit of reflecting on matters of economic policies. So I thought I would make use of this occasion.

All of you, the students, are going out into the big world and some of you have already been there working. But you will be experiencing with your new knowledge out there and it is indeed true that when you are out there in the world taking practical decisions, a lot of decisions will have to be everyday decisions done quickly, done efficiently, done with a lot of sincerity of purpose, which makes a very big difference. But, occasionally one also pauses to think through larger questions of life. Yes, in most of your positions in every day life you will not be able to affect the larger decisions, but if collectively, we think of the big choices that India faces and think through, analyze in our own heads, it makes for a richer electorate, a more thinking population and through that better policy making. You have to balance, of course, the practical needs of every day life and decision making and some of the reflections that you do. I mean since I have been in the world of academics, I do also know that at times it is very easy in the academic world to be so far removed from every day decision making that the thought becomes so abstract that it is not useful. But there is scope for mixing the two and balancing the two.

Speech delivered by Dr Kaushik Basu, Chief Economic Advisor, Ministry of Finance, Government of India, New Delhi, Seventh Annual Convocation of the Post-Graduate Programme in Banking and Finance of National Institute of Bank Management, Pune, on March 10, 2011

What I will concentrate on today is talk a little bit about India's policy challenges, but focusing on particular matters of finance and money. It is a bit risky doing that here; it is like carrying coals to new castles. This is an institute of banking, but I could not let that opportunity go so I thought that instead of just generally addressing questions on the policy challenges confronting India I will spend a little bit of time raising some questions which, as you go into the world of banking and finance, there will be occasion for you to think about. And you must remember that occasionally a big idea can just attain public space, and begin to gather steam and then have fine real application. Working in India, I am in policy now for little more than a year, there have been highs and lows no doubt. When you are working in policy making, in government in a policy making capacity, in the front lines, no doubt there are highs and lows. I have to tell you that with all the news and not very favourable, news that hits the news papers now with regularity, there is also a satisfaction of having joined government recently.

I can tell you that there is also a body of professionals, small number, not large, among the politicians, among the bureaucrats, who are absolutely top class. And when you interact with them, you feel the only interest is the professionalism, they are here on this huge project which is the project of India and when you talk to these people and again am stressing I am not even for a moment pretending that all of government is such people, but even if you have a handful of such people, and actually I should say, Dr Subbarao is here, he is a fine example of that, that you can count a handful of people with whom when you sit down and talk you really begin to feel hopeful for India. And there I have been talking to American policy makers, policy makers in Europe, who tell me that you talk to this small group of very very professional, intellectually well equipped and committed people in India, India really stands out as quite a remarkable country. So through all the bad news that we do read in the news papers, and we should not hide away from that, we have to confirm the bad news that we read.

It is also a time of great hope for India. Coming to economic policy, I know growth is not the last word in the end growth and must be an instrument for better quality of life for people who are disadvantaged and marginalized, to be brought into the mainstream for their lives to improve. So to that extent we do give a lot of attention to growth. And India's growth story indeed has been absolutely remarkable. Even 15-20 years ago when I was a Professor at Delhi School of Economics, I could not really imagine that India would be considered to be among the frontrunners of globally growing countries. And not considered that by Indian media and Indians but by the international media and international observers as is the case today. India's growth rate this year, which is an estimated growth of 8.6 per cent, really stands out in the global scenario where, after the global downturn, most of the countries are beginning to hobble back to normal days of development. India is already growing at 8.6 per cent; China is growing phenomenally, but it is a small

cluster of four five countries that are really being described as engines of global growth. For India this is a new description that was never put on us and with that comes a huge, a huge responsibility. I don't want to go into details of this story and a lot of you will be familiar with that but there is a banking aspect to this which I thought I should mention here since this is the Institute of bankers. Growth depends on a variety of variables. But among all the variable that drive an economy's growth a couple that stand out as extremely important variables are savings and investments. So the fraction of the national income that is saved and invested, being invested in machinery, in factories which enhance future growth, is extremely important.

If you look at the fraction of India's national income that is saved and invested, it used to be very low till the late 1960s. Only 12 per cent 13 per cent of our national income we would save and invest. That rose in two steps, once it rose from the late 1960s to the late 1970s, the fraction of the national income saved and invested went up from about 12 and 13 per cent to 21 and 22 per cent by the late 1970s. What caused it, there is a lot of dispute on this but on the fact of the saving rate having increased, every one agrees. There is a dispute and a controversy on the cause of the savings rate increase, but I do feel that the banking played a very very critical role in it. In 1969 the banks were nationalized. The bank nationalization was a huge decision, but one consequence which did follow from that was the directive given to banks to open up branches in remote areas, far flung areas where it may not be totally profitable for banks to go. If you look at the number of bank branches in India there is a steep rise from the late 1960s to the late 1970s. And the savings rate also picked up during that time and my belief is that having these branches spread out there is still a great amount of scope for doing more on that. As a result of this, ordinary people were able to put away their money as savings and as that savings picked up from early 1980s India's growth picked up. There has been another round of very sharp increase in savings rate which happened around 2003. In the year 2003 India crossed over into saving and investing more than 30 per cent of its national income. Now 30 per cent plus savings and investment used to be treated as an East Asian prerogative. Only East Asian countries could do that, they used to do that and they used to grow at remarkable pace.

From 2003 India crossed over into plus 30 per cent savings and investment rate and with that India's growth rate also picked up once more in 2003 and even more from 2005 and after that it has been just a remarkable round of growth and the savings are indeed fueling this in which banking has a very very big role to play. Huge role to play, actually depending on how sincerely and how well you conduct your career in banking. Yes, each one of us is a small player in this huge project, but believe me, together we do make a big difference and just in the sense that we tell people that you must go and vote though your vote is a single vote and in itself

it matters very little the collectivity of such actions matter a lot. You have to keep that in mind. Let me use this, since this is an academic institution, to address, bring to your attention a couple of vexing questions about the world of money and the real world of goods and services. This is actually in economics. It is considered one of the hardest links. One of the reasons why finance and money, to me, is one of the hardest areas of policy making is that it is the odd mixture of science (because we do have a lot of empirical evidence of how various variables correlate with one and another) and a lot of theory. But it is also partly an art and intuition. You have to bring that to the fore because in the end there are no known formulae for handling this world of finance and its link to the world of real goods and services. I remember this was driven home to me through a very trivial example years ago when British Airways started this, now virtually all airlines do that. They put a little pouch in with each seat. Those days British Airways used to say that when you are traveling from one country to another there must be loose change with you which will be of no value in the other country and that you should put it in that pouch and that British Airways would give this out to UNICEF. Soon, within a year or two, British Airways would announce that they have now got a million to two million dollars just through this small change, change which people would not have used being put into this pouch and that is a great value to the world.

I remember once on one of these flights a very serious thought troubled me. If it was indeed true that these coins I would never use, they would lie in the drawer, and I was putting these into the pouch and handing them over to British Airways, it was not so clear that I was doing good for the world because money that would not have been used and would have struck in the drawer I was putting that back into global circulation. This meant that I was creating money supply in the world, and actually this was true. By putting that money into the pouch, you were adding to the effective money supply in the world because you were bringing this money back into circulation. So it is possible that when millions of people do this there is a little bit of global inflationary pressure being generated from this act of putting this money into circulation. The bottom line of this is that, yes at one level it is good, you have put in this money and it goes into good use presumably through British Airways by giving it to charity. But the world of money and the world of real goods is an extremely complicated relationship and through simple acts you can begin to change this connection with no particular action being taken by the Reserve Bank of India, by the Ministry of Finance. Ordinary human beings changing their behaviour can begin to make an impact. This has to be kept in mind in this very very complex world. This morning as I came in, one of your professors was reminding me of a short story which was written by a well-known Bengali writer Shibram Chakraborty which illustrates a relationship between the world of banking and the world of goods and services and I thought once I was reminded that I must tell you about this story because at one level it is a very

simple story but it highlights two very important principles of money. I can assure you the author was not trying to do that, he was actually a medical practicing doctor who wrote this humorous short story in Bengali in the middle of the 20th century. The story is as follows:

There is this person, the author writes in his own name as if it was he, Chakraborty, who gets up one morning and finds that his landlord is after him to collect the rent which Chakraborty has not paid. Rs.500/-. He does not have the money. What will he do? Then Chakraborty remembered that in school he had a very gullible friend called Govardhan. So he goes to Govardhan and says, "Govardhan, I have not seen you for years, but believe me, I think about you, you were such a good friend" and then quickly gets to the point and says, "Can you give me Rs.500/-? Today is Saturday, I assure you that I will give it to you on Wednesday." With some persuasion he manages to get Govardhan to part with Rs.500/-. He goes and pays his landlord; he is very happy and his problem is solved.

Then, of course, Wednesday comes and he realizes that he has to pay back the money to Govardhan. What do I do? Then he remembers that in school there was another very gullible friend called Harshavardhan. So he goes to Harshavardhan and says, "Harshavardhan, you have been a friend of mine. I haven't seen you, but I think about you being such a close friend. Look, I need Rs.500/-. Today is Wednesday. Give me Rs.500/- I assure you that I will give it back to you on Saturday." Harshavardhan parts with Rs.500/-, and he takes that Rs.500/-, goes to Govardhan and says "Govardhan, a promise is a promise, and here is your money." Gives it to him and he says, "Look, my repayment record is 100 per cent; I have taken and given back to you."

But of course, Saturday comes and he needs to pay back Harshavardhan. What will he do? He goes back to Govardhan and says, "Look, my record is perfect. I take money and give back. Please give me Rs.500/-, I will give it back to you on Wednesday." He goes and gives it to Harshavardhan. Then his life becomes Saturday and Wednesday. Every Saturday Rs.500/- from Govardhan, every Wednesday Rs.500/- from Harshavardhan and he keeps circulating this. The end of the story is not important, but I will do injustice to the author if I don't give you that. One day he is walking down the street when to his dismay he finds Harshavardhan coming from one side, Govardhan coming from the other side. So for a moment he thinks he is finished. Then, he is a clever person, he relaxes and says, "It is such a pleasure meeting the two of you together. I have been wanting to get together with my own school friends. and I have a simple suggestion to the two of you which, you will find, will leave your situation completely unchanged. It will save me a lot of time and hassle. Every Saturday Govardhan give Harshavardhan Rs.500/- and every Wednesday Harshavardhan give Govardhan Rs.500/-, and leave me out of the picture" And he vanishes from the scene.

This story actually illustrates something of deep importance very well. First of all, that by loan juggling he virtually created money. What this person did was gave Rs.500/- to the landlord. The landlord was happy. And for a long time Govardhan and Harshavardhan felt that their asset position is unchanged. Occasionally, from their savings someone is taking money, putting it back but it is secure. So they both feel that asset position is unchanged and Rs.500/- got created out of thin air which was handed over to the land lord who got it. Over here there is no interest rate. So it is not building up, otherwise if there is an interest then, overtime, it goes up to something which is unsustainable. But you can create this beliefs through which you can effectively infuse effective supply of money.

There is another important lesson which comes from the other area in which I have taken a lot of interest which is the fragility of financial system. This story illustrates it very well. You know, by the way, this kind of a thing is not just a short story. At one level these are things which have been practiced and it has now been very well recorded, that in 1992 when the Latin American countries went into a crisis, Peru was exactly doing this game. Take from one bank, pay other bank that Peru owed money, and take from this bank and pay the first bank and it was loan juggling with big banks for quite some time and in fact, I think it was William Klein who makes the point that if Peru had been allowed to do that for some more time, Peru may have worked itself out of the crisis. So there are questions that arise. There is another thing that always catches us by surprise. Financial crises, unlike real goods crisis, come on very suddenly and this is because, people are writing about this, that beliefs are extremely important in financial matters. What you think the other person thinks and what the other person thinks that you think. Mutual beliefs are extremely important. And you can see this in a moment.

Takes this story, Harshavardhan and Govardhan very long names, let me call them H and G. Each one believes the other banker, H believe that G will continue to lend to Chakraborty, and G believes that H will continue to lend, then at one level it is safe for you to give money to Chakraborty because Chakraborty has access to the other bank and will keep paying you back. The trouble arises if, at some point, H begins to believe that G will stop lending to Chakraborty. Then H will stop lending. Even more, if H believes that G believes that H will stop lending, H will stop lending. Why because if H believes that G believes that H will stop lending, H believes that G will stop lending very soon. So H will stop lending sooner. And in fact you can go on if H believes that G believes that H believes that G believes that H will stop lending, H will stop lending. These kinds of structures have actually been analyzed in a literature in finance where the beliefs are very important and we know this from olden days when there used to be bank clams. Beliefs could precipitate a crisis and so understanding that also becomes extremely important.

Let me just pause for, not pause, but end my discussion by speculating a little bit into India's future and I will stop with that. India stands today at a very critical juncture. It is one of the really new comers on the global block. Its fast development record is not very long. China began growing. East Asian countries began growing from 1960s. In 1962, 1963 South Korea was growing at a very very rapid rate, but we, put in reforms which are extremely important. China has been growing at a staggering rate from 1978, 79. Even before that, during the period of deep communism, China was growing fast enough, but it would occasionally have these precipitous declines in GDP. Growth rates which were minus 20 per cent to 22 per cent which is just unthinkable in India but it is from 1978 to 1980 that China did the take off. India's take off is much more recent. The first round of rapid growth was 1994 to 1997. It was three consecutive years that India grew at the rate of approximately 7% per annum. In 1997 India's growth rate slowed down, but we know, while that happened, the East Asian crisis came. And that was also a bit of a reminder of the Harsha-Govardhan story that I was telling you. People have speculated that the East-Asian crisis somehow sparked off crisis in Russia, in Mexico in far away places.

Again, when it is a financial crisis, there is a lot of what is called infection in the literature. That when something happens somewhere, it sparks off thoughts elsewhere and from that it can spark of a problem and that spreads. India that time was not quite as exposed to International markets as India is today. So our growth rate went down but not in a huge way. Then India's real rapid growth started in 2005 to 2008. We have now and then slowed down with the global down turn and are now getting back again to where we were. The challenges are very large in front of us. I believe that we are here to stay on the rapid growth path and the country is going to see good times in terms of the economy. There are lots of things in politics that we have to manage, we have to do better, we have to work and civil society has to be active to keep this up. But there are new challenges that we will face with time and I will just talk about one particular kind of challenge in the new world that the kind of thing that we have to keep in mind and as bankers you may like to analyze.

This came to light during the East-Asian crisis. You know in the olden days when you had a relatively closed economy a stock market depended, of course, on real factors in the economy and peoples' beliefs about the stock market. But in 1997 when Thailand and other countries went into the deep crisis we realized that there was a very strange kind of intertwining that was happening between different markets which had not happened earlier. And now as India becomes a globalized country we will have to confront some of these problems. See, if money into the stock market goes in from the domestic players, if there is going to be a fluctuation in the exchange rate, the stock market, yes there are indirect ways in which it gets affected, but not in a direct way.

Think of the 1997 East Asian crisis and India is getting into a domain of that kind. If a lot of the money into the stock market is coming from abroad, people who bring in that money from abroad are looking not only at the stock market in deciding when they should pull out the money, but they are also looking at the exchange rate to decide when they should pull out their money. So if they expect the exchange rate to move in a particular direction since they will in the end take out the money from the stock market and then out of the country. They may decide to move their money out of the stock market not because they are expecting the stock market to do badly but because they are expecting a change in the exchange rate. But that could affect the stock markets indicators because the money comes out of that. The exchange rate market begins to get intertwined with the stock market in a way that did not happen in an earlier world but is now happening in a globalized world. People then raise questions if globalization is worth it if with globalization we will have so many of these problems.

To me the answer is an unequivocal 'Yes'. Globalization is a great vehicle for growth and development. If you don't have that, yes, you don't get some of the fluctuations. What happens in Russia, what happens in Thailand, in Korea does not affect you if India was not globalized, i.e. if we were sheltered. But that would mean you would be so poor that there would be no possibility of growing, getting or doing any worse. So it would be stable, but stable at a very low level.

Once you begin to take advantage of globalization, your per capita income rises, the country becomes better off, but, yes it is true, that there is space at the bottom, so there will be the occasional crisis and there is no getting from that. That is the way the world works. There will be an occasional crisis and you will have to deal with it. But on balance it seems to me that it is purely worthwhile that we embrace globalization. It is not all good; there are countries and regions that have done badly with globalization. Fortunately India, from the reforms of 1991, when India was opened up, the country has done very well through globalization. Yes, we will have to be now ready to take in some of the fluctuations in the world out there coming, flowing into India because we are an open economy. But by virtue of that we are today better off, and even more importantly, we have the prospect of being even better off and distributing, which is very very important. Distributing the spoils of the growth much better in the population.

Thank you very much.