India won't get away with fiscal deficit easily: Expert

Professor Gita Gopinath, the second Indian after Amartya Sen to be a tenured or permanent professor at the famous Harvard University economics department, spoke about her outlook for the euro, US and Indian economy. She began her studies in Delhi’s Lady Shiram colleges and the Delhi school of economics.

Today she is known for her contribution to the field of international macroeconomics and finance, the hottest area of research thanks to global banking and sovereign debt crisis.

Talking on the Indian economy, Gopinath says, "I don’t think India will get away with our fiscal deficit of about 7% simply through growth and therefore through revenue creation." She further adds that there are some structural issues to be dealt with.

Below is a verbatim transcript of the interview. Also watch the video.

Q: Let's start with the euro. How do you think the euro zone is going to look six-12 months down the line? Will the worst have been over? Will the euro itself have fewer countries using it as their currency?

A: What we have to think about is whether countries like Greece are going to follow the example of Argentina which in 2001-2002 got a lot of bailout funds from the IMF and defaulted on its debt nevertheless or will it follow the countries like South Korea or Mexico, which were spared default because of all the bailout that they received. So if we do a cost benefit analysis, it is hard to see how Greece would avoid some significant restructuring of its debt. Its current debt is at 115% of GDP, which is very large. A part of taking these bailout funds means taking on severe austerity measures on the economy.

In terms of restructuring they would gain by getting rid of this kind of severe austerity measures. On the cost side, they will have to see what kind of penalties the eurozone will impose on them. That is not clear at this point how the other euro countries are going to deal with sovereign debt default on the part of Greece. So it's unclear exactly what the costs are at this point. At this point it seems quite hard to imagine how Greece will avoid some kind of restructuring in the near future.

Q: What about the euro?

A: What's interesting is until now the probability of the eurozone imploding was an exact zero, but now the markets are factoring in some trivial possibility of a collapse of the whole eurozone area. Though it's a tiny possibility, if it happens it will be a catastrophic event which means its getting priced into the markets. I actually do think that the cost of having a complete meltdown of the whole eurozone area is going to be so large that it is even now a very small probability event. On the other hand markets like Greece, Portugal or Spain might face stronger restrictions and requirements for being part of the eurozone area. This is a more likely event.

Q: Is there a chance that citizens of Germany and France refuse to pay for Greek and Portuguese deficits and ask these countries to get out?

A: I agree. The fact that the risk has gone from being zero to positive, is a matter of concern. However, I think economies of Germany and France will probably not think it in their interest, though I can see how the population is concerned about the bailouts are being handed out and how that's going to eventually be borne by them. In the larger scheme of things the cost of having a euro restructuring is going to be immense in terms of financial institutions and just trade contracts. I find that a low possibility. If it so happens that the countries of Greece or some other economies are asked to leave the euro area, one could actually make an argument for why that would actually strengthen the euro.

Right now all the bailouts that are being handed out are a source of concern for the euro to the extent that can be inflationary for these markets. One could actually make an argument that with some countries leaving the euro area that could actually strengthen the euro currency in which case countries like India have invested in the euro would probably be better off.

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Q: Let me come to the US now. Are you reasonably convinced that there won't be a double dip recession in the US?

A: Yes, everybody is looking out for that at this point. In the case of the US, there seems to be increasing evidence that the US recovery or its positive growth has actually gained traction.
If you look at the inflation numbers the US CPI actually fell which means a deflation of about 0.1%, it is very likely that the monetary authorities will keep interest rates low for some time to come. So that stimulus will stay.

On the other hand the fiscal stimulus is much harder bargain to push given that the fiscal deficit is over 10% and this is clearly not a sustainable trajectory. So it would be interesting to see what happens when the fiscal stimulus is withdrawn. If I had to project whether the US will have a double dip recession, I would say that that is a low probability event at this point. The countries that are more susceptible to greater turbulence are the economies of Japan.

UK is still at zero growth with some possibility of positive growth in the rest of this year, but economies of UK are very likely to be hit by a second recession especially with global demand coming down. The eurozone area of course is in the throes of a serious crisis at this point of time. So I would think that the US is a little more stable ground relative to other markets

Q: What's your view on India? Do you think that the 8-9% growth trajectory is a given? Do you think that the fiscal deficit is going to be a serious problem that will come to haunt us or do you think that will get taken care of by the sustained growth pace?

A: Yes and no. The Indian economy has performed remarkably through the crisis and whole global recession and it is one of the reasons that global growth is positive at this time. I don't think in Indian we can escape the fact that our fiscal deficit of about 7% and the projection of high numbers is something that will go away simply through growth and therefore through revenue creation.

There are some structural issues to be dealt with. The rest of the world has a very low appetite for fiscal deficit in emerging economies. The US can have a fiscal deficit of 10% and the rest of the world is willing to kind of ignore that. In a market like India that is less likely. So the two factors of fiscal deficit and inflation will continue to play some concern among investors globally and that will feeds back into the economy through future projections of growth

Q: Some people believe India escaped the worst because it was proactively over cautious about markets. Others say it was just fortunately behind the curve on market sophistication. What are your thoughts? Should India push ahead with market reforms with greater vigor now?

A: That's a great point and I think the research that we have so far and the IMF agrees on this right now is that prescribing very open financial and international financial liberalisation has not worked as they expected. There is very little evidence that having large scale capital account liberalisation has contributed to growth in a particular economy. So the extent that India was cautious about the kinds of financial instruments it would was probably that paid off whether accidentally or not. I do think the strategy where one is cautious about financial liberalisation especially in an economy where there are still issues with the financial architecture is a sound strategy.