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"Anti-outsourcing not in US interest"

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Gita Gopinath, 38, is the first female Indian-origin full professor at Harvard University's economics department. Widely considered an authority on international price fluctuations and business cycles in emerging economies, the young professor, a Delhi School of Economics alumnus, says there's a lot left to be done in improving the financial system in countries such as India and China. She is of the view that to prevent a slowing of growth, India needs to focus on education "at all levels" which alone can ensure a more skilled labour force.

Gopinath, an admirer of cricket icon Sachin Tendulkar and writer JK Rowling, says she hopes that the Federal Reserve, under the chairmanship of Ben Bernanke, could help the US economy tackle problems arising out of rising unemployment and a shrinking housing market. The Kolkata-born economist, however, regrets that the outsourcing issue, which is on top of the agenda of US President Barack Obama who is visiting India early next month, is deeply political at this point. Excerpts from an interview.

Q. What are the most interesting findings from your studies on business cycles?
Business cycles in emerging markets behave differently from developed markets. For emerging markets, there is a sense in which "when it rains it pours" . That is, when the economy is booming that is also the period when the country receives large international capital flows, and the interest rates at which it borrows is low and fiscal spending is high. On the flip side, when the economy shrinks, capital flows dry up, interest rates rise and fiscal spending collapses. Consequently "good times" and "bad times" have a tendency to turn into "great times" and "terrible times" . There is no countervailing force that moderates cycles, unlike in developed markets.

Q. What do you think are the policy steps that helped countries such as India and China lessen risks of exposure to the global financial slowdown?
India and China have many restrictions on international capital flows. This automatically reduces direct exposure to a global financial shock. Domestic financial intermediation is also heavily regulated. The crisis in the US market is increasingly being attributed to esoteric financial instruments such as credit default swaps and the high leverage that the unregulated non-banking financial institutions took on. These factors were not important in India and China. Of course, this does not mean that India and China have a better financial system. In both countries there is large scope for improving the financial system. The recent report of the committee on financial-sector reforms in India, chaired by Raghuram Rajan, provides a terrific blueprint to work off of.

Q. Where does India stand globally?
Compared with 10 years ago, India has gained alot of prominence in the global economic arena. India is on everyone's radar for good reasons. It is a fast-growing economy and this is a transformational phase for the country. There are many pluses, with the demographic trend in our favour (as compared with China, for instance). It is predicted that by 2035 we should have the world's largest labour market and we (India) have a vibrant private sector, so there are many reasons to project continued growth. But to prevent a slowing of growth we need a more skilled labour force. This means education at all levels has to be a priority, infrastructural improvements are crucial and better governance is essential.

Q. How costly is it to developing countries that their external borrowing is not in their own currency and they suffer from "original sin"?
There are costs and benefits to issuing debt in one's own currency. The benefit is that one reduces the currency mismatch when your assets and liabilities are in the same currency. The cost though is that since lenders face a higher exchange rate risk when lending in rupees, for instance, they will make it more expensive to borrow. At this stage, the costs outweigh the benefits which is why one observes most international borrowing in dollars. China is working on making the yuan amore international currency. If the Indian rupee also gets viewed as a currency with low risk then the "original sin" issue goes away. (Original sin is a phrase coined by Ricardo Hausmann and Barry Eichengreen. It refers to the inability of countries such as India and China to borrow externally in their own currency, unlike say the US that has almost all of its external debt denominated in dollars).

Q. You have said earlier that you have faith in Federal Reserve chairman Ben Bernanke, and that you expect him to manage the current crisis well. Do you still stand by that statement?
Most economists will agree that the policies that Bernanke adopted following the onset of the crisis helped prevent a global financial meltdown. Some of the programmes that were put in place to prevent a collapse of the financial system such as the "troubled asset relief programme" have performed surprisingly well. It is widely perceived that the programme will now cost the US tax payers a fraction of what it was initially projected to cost. The big issues in the US are now high unemployment and the anaemic housing market. It is still uncertain how the Federal Reserve's policies will be able to alleviate these problems. However, I think we can be certain that under Bernanke's chairmanship, the Fed will do everything it can.

Q. You said high unemployment and the anaemic housing market are the two big issues in the US at the moment. In that sense, it is normal that outsourcing work to India and other countries causes some concern. But isn't the US government being excessively anxious about it? Do you think the Obama administration's anti-outsourcing policy could hurt the country's economy, or at least its technology sector?
President Obama himself had said earlier "India and China will help the growth of US. US tech firms have thousands of jobs, but not enough talent at home".

Yes, the outsourcing issue is deeply political at this point. One of the strengths of the US economy is its ability to most efficiently employ resources both domestically and from around the world and outsourcing is one such example of this. It cannot be in the US's interest to move away from this philosophy and my guess is that any action that restricts the free flow of goods and service trade will be limited and of a short duration.

Q. Now, how much do you agree with the criticism that policymakers and central banks in major economies of the developed world let financial markets remain a 'Wild West' for long by not containing the risks of hyper-speculation ?
There was certainly a lot of faith that the markets would work efficiently and the creation of all these esoteric financial instruments would only be a net benefit to society. This was an over optimistic assumption that has been appropriately criticized.

Q. To what extent do you think currency manipulation (intervention) by countries such as China and Japan likely to hurt the US economy by creating a dent in the country's trade deficit? Don't you think that any country running an artificial trade surplus is depriving other nations of much-needed sales and jobs?
What matters for the trade deficit is the real exchange rate, not the nominal exchange rate and it is very hard to explain how currency intervention can keep real exchange rates depreciated for an extended period of over 10 years as has been the case for China. In the case of China, there are other factors such as the large supply of cheap labour from rural areas that has a first order effect on the real exchange rate. So clearly, while letting the yuan appreciate can reduce the US trade deficit, there are other fundamental forces at work that will keep Chinese products very competitive in the international market. As for Japan, their gains are temporary.

Q. Where do you stand in the "decoupling debate"?
With all the globalisation that has taken place, countries are a lot more interdependent and therefore "coupled". However, India for all of its increased exposure to world markets is still a fairly closed economy, both in its share of world trade and foreign direct investment. It certainly should look to its internal markets to grow and the fact that India has continued to grow at high rates despite the slump in the advanced economies is a positive sign. In general, with the right policies and good governance India should be able to experience many years of robust growth. Much more than monetary and fiscal polices, I think long-run development policies and good governance are the biggest issues to deal with.