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Double-dip recession in US? Not quite, say experts

The conference organized by the Reserve Bank of India has attracted some of the best minds from Central Banking, from policy making and from the world of economics, people who have actually dealt with Financial Crisis in their respective countries.

Andrew Michael Spence, Economist, Professor Emeritus at Graduate School of Business at Stanford University. He is a noble price winner in 2002. Central Banker, William Poole, Senior Fellow, Cato Institute, the former Chief Executive, St Louis Fed Reserve until recently as 2008. He was very intimately involved with how the Fed responded to the financial crisis and Policy maker, William White, Chairman, Economic Development Review Committee, OECD and Former Economic Advisor & Head of Monetary and Economic Dept, BIS, some of the eminent guests at the conference discuss the global economic scenario in an exclusive interview on CNBC-TV18.

Here's a verbatim transcript of the interview on CNBC-TV18. Also watch the accompanying video

Q: In your speech at the conference, you referred to a study of 13 countries which have managed which have managed 7% plus growth continuously for a period of 25 years and when you pointed the common characteristics you said they were marked by high public investment almost 5-7% of GDP that they were marked by basic macro economic stability, people was an asset etc.

Let me take high public investment - did that come largely from the government. I am asking you because the charge in India is that public investment or infrastructure investment is not happening because of the absence of bond markets. Was the bond market so critical to these 13 countries?

Andrew Michael Spence: No not really, the crucial thing is to get the investment done as a support base for private sector investment and dynamics. There are parts of public sector investment that can be done with private financing and that is not a bad idea partly because governments have trouble allocating this portion of their budget to investments but the government is a are very important player and has to do some of it.

Q: You said that India and Vietnam are almost there in those 13 countries that have been able to manage relatively high rates of growth. Since you have studied India in a comparative sense, what would be the stumbling block or blocks according to you?

Spence: I don't think really there are any. I think in India probably most prominently it's about to join this group, it's just the growth acceleration was somewhat more gradual and started slightly later. So it's just a question of time. But as far as I can tell the strategies and policies are fundamentally in the right direction and the structural dynamics, in the economy that are underpinning of sustained high growth are pretty much all there.

Q: Coming to the United States, how are you looking at the economy at this juncture - do you think at least fear of a double-dip recession is genuinely behind?

Spence: Not quite, I don't think a double-dip recession is the most likely outcome by any means. I think the more likely outcome in this is and probably the majority view is a fairly long difficult recovery which is sometimes called a long flat U or a long slightly deep U. The reason for that is that the structural undoing of the imbalances is the de-leveraging process the restoration of household balances the stabilization of the housing and the commercial real estate markets, all of these things just take time, you cannot do them overnight. All of that is going to essentially act like a drag on the economy. So I am expecting a sort of difficult recovery and then probably a period of slower growth after that as well.

Q: Some organizations like the IMF have estimated maybe a 2% growth for the developed world in the current year; would it be even as good as that?

Spence: I would be a little more pessimistic than that on the other hand the IMF has a lot of data and information. But I think with the trouble, difficulties in Europe on the fiscal side and both political and economic challenges in the US, I think a 2% average in advance courtiers would be on the high side and a good outcome.

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Q: There are a series of steps that the Obama administration is taking against banks, the Volcker Rules as they become famously known, do you think they will succeed – succeed in a sense will they even be implemented and are they on the right track now?

Spence: Yes, I think there was a big shock with the senatorial election in Massachusetts and the Obama administration seems to be in process of reshuffling the agenda and focusing more on jobs and regulatory reform and restoring growth in general and I think that is a good thing. Now the political situation is quite divided now with the electorate somewhat angry and disappointed at the progress so far.

So I think it is hard to know whether some of these are financial markets and regulatory reforms are actually going to pass and in what form. My personal view is that the Volcker rule isn't a bad starting point, provided it is accompanied by a pretty vigorous restrictions — kind of counter-cyclical restrictions on requirements in the area of capital, margins, reserves and so on for the economy and that leaves open the question of how to handle hedge funds and the proprietary trading.

Q: How do you see the world in the next two years or even three years, do you see any tectonic shifts to emerging markets, to emerging economies and how will that play out for instance in the world of currencies where perhaps the dependence on the dollar still remains?

Spence: I think the high growth area is likely to be the major emerging economies and more broadly Asia - East and South and that is a big change, these were high growth areas before but now the relatively high is much bigger. That is a confidence booster for India and China and the region generally.

India and China, in particular, are special in the sense that they are rapidly in the process of acquiring very significant impact on the global economy, China a bit ahead of India but not that much measured in years and that carries with the responsibilities and they are landing on countries that are still not very rich as measured in per capita income terms and that is a hard problem.

It involves balancing domestic issues versus maintaining the global system issues and the honest truth is when you are in a developing country, you would prefer to have the domestic agenda be the focus and you are being forced in some ways to take an important and growing world in the G-20 and in other places where the global economy is put together and reassembled.

Q: You have studied the Chinese economy in some depth, there have been recent tightening moves, the reserve requirements have been increased as they have been in India thereafter, how do you see the economy panning, there are lots of fears about huge capacities being created, huge imbalances. It is still opaque for someone who is not so closely associated with that country, do you think that these imbalances will implode the economic growth in some fashion but do you think the Chinese have a fairly decent record inspite of all these skeptics?

Spence: Yes, they have a very good record and along history in a very rapidly growing country like India now and China, you constantly are getting hitting bottlenecks and potential imbalances. I sometimes characterise it as sort of the difference between driving a Morris Minor on a city street and a formula one car at 280 kilometres an hour, things happen pretty fast.

The Chinese have a track record of aggressively and quickly getting on these things, I think they do have a potential inflation and asset bubble problem and it looks like they are responding quickly to that.

They also have very major structural changes, both macro and micro economic. That shifts the economy away from a historically important labour intensive process in manufacturing industries and to drive the growth from the middle-class and domestic consumption more and these are not easy transitions. So I think the Chinese have this pretty well in focus and now it is a question of getting the job done.

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Q: Would you say that the way US economy evolved from the crisis after the huge amounts of fiscal help will at least not go back to another recession that it maybe a weak recovery but it will not be a recession?

William Poole: I don't think we will have a double-dip recession as some people put it. It does look like we are going to have a slow recovery. What worries me most about this recovery is the failure of the government to provide incentives to business fixed investment. We had an economy that is too consumption oriented and we need to have an economy which is more business investment oriented to drive the economy forward.

Q: Do you see it coming- do you think the Obama Administration is fixing it at all?

Poole: I don't see anything in the works that would provide the incentives.

Q: Every time you see one of the sovereign governments on the verge of default, there is a movement towards US dollar assets especially treasuries – do you think that this safe haven status which the dollar still enjoys will be able to help the United States Government probably spend is way out of this problem because there is an appetite for US treasuries after all?

Poole: The appetite is there but there are symptoms of a very great degree of confidence in the US financial markets and in the United States government. But, if the Federal Government in the United States doesn't get the fiscal state under control then, the United States would lose that advantage and countries and private firms will start to go to other currencies that are stronger. So the US has a very-very serious fiscal situation ahead of it.

Q: It certainly has but do you think the dollar is really under threat at all as a reserve currency, it may have its problems but it doesn't seem to have competition?

Poole: Not yet and the market has confidence that the US will fix the fiscal problem and I think I have confidence. But I think we do not see signs as yet that the Federal Government is coming to grips with the fiscal situation.

Q: How do you think the Chinese Central Bank Policies may evolve?

Poole: I have no special knowledge about what China is planning. There seems to be widespread agreement, I was thinking about the discussion I hear today, widespread agreement that it's not in China's interest to continue this policy indefinitely. I understand China has some very substantial problems. It's still a country with a low per capita income and yet it's a waste for China to accumulate dollar reserves indefinitely with a very low rate of return.

Q: One of the more fashionable jargon that has come up is the word 'New Normal', but yet its certainly something that we should understand- how do you see the New Normal in the global economy, would it be a long period of developed markets or developed economies growing rather slowly- how do you see the New Normal?

Poole: Unfortunately the 'New Normal' at this point is not well defined. What worries me most about the situation in United States and it would also apply to Western European countries is the assumption in the markets which I believe is accurate. Unfortunately, that any large banking firm or a large financial firm that gets into trouble will be bailed out and that is not a long run sustainable situation. So we need to change that situation because it's a source of instability, it cannot be a New Normal that we have this indefinite period where firms can be bailed out by the governments.

Q: Do you think its becoming so much of an expectation that they will be bailed out?

Poole: Absolutely, the large financial enterprises can raise funds more cheaply than their smaller competitors and as a consequence the market assuming that the risks are less because the government will bail them out that means that the a large enterprises have a substantial advantage over the smaller enterprises the financial enterprises that means they only grow larger and we will have a banking system that collapses into fewer and fewer, larger and larger firms that is not a source of strength for the US, it's a source of vulnerability.

Q: In that context you would support the Volker-Obama proposition that banks should be made smaller in the US?

Poole: I am not sure I would do and the reason is that I believe at the end of the day trying to drop a list of permissible activities will produce a game between the regulators who try to define permissible activities and the accountants, lawyers and consultants who try to go around the rules and I don't think that is a stable situation.

Q: So what should the administration be doing, they seem to be getting their intentions right but you think that there methods won't work?

Poole: I would emphasize and have emphasized including discussion this morning, I would emphasize two things that are to be done; one we have to have much more vigorous capital requirements than we have today and they are to be specified in the law. They should not be subject through the regulatory discretion.

The second thing is we are to end the tax incentive for leverage. We have an incentive for leverage that makes no sense. Why do we encourage companies to become more leveraged, to take on debt and households too? We could change the incentives for leverage by phasing out the deductibility of interest on all tax returns and reducing the statutory tax rates so its not a method of raising more revenue. We have a subsidy for leverage, it makes no sense.

Q: We have to but we are much earlier in the curve in terms of beginning to leverage.

Poole: You should learn from our mistakes.

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Q: Is the manner in which the European countries have rallied to the Greek government, can one say that the problems of sovereign debt at least in the euro zone are behind us?

White: I think there are two sides to this. On one hand there is a hope that these actions will calm down the market. I have noted that the Europeans have put a lot of emphasis and I think Moody's in addition were at pains to note that the problems that Greece faced are significantly more serious and deep seated than the problems faced by many of the other countries including Portugal and Spain. Ireland, I think, stands out as a country that has taken this bull by the horns and decided to do what needs to be done to get the fiscal situation under control. I think people hope that the Greeks would wind up doing the same thing.

Q: There is still a lot of worry about the huge fiscal deficit sizes of countries even other than these vulnerable ones for instance the UK and for that matter even the United States, how do you see this evolving, will this mean that investors will turn away from those bonds, how can that play out?

White: I must admit that I have a bit of a conflict here at the analytical level because if you do have a world in which a large number of countries are operating sort of well below full capacity. It is very hard to envisage the concept of somehow everybody being crowded out by higher interest rates the governments themselves of course when they spend the money in effect to creating the income that creates the saving that buys the bonds. Fundamentally, there ought not to be a problem. Having said that, there is no question that markets can distinguish between different kinds of borrowers and they can make life very difficult for particular countries. I find it hard to see how they could make it hard for all countries.

Q: Would you worry about inflation now in the next twelve months or do you think that this large underutilized capacity will avoid it, there is a lot of growth coming in from emerging markets?

White: Yes, I think that on the inflation front, in the near-term there is so much excess capacity everywhere at the global level that I don’t think inflation is a problem. Having said that, two caveats – one is that if we continue to have a build up in commodity prices, food and energy which of course would have a particular impact on countries like India that could be the kind of cutting edge of what maybe coming later.

The second thing that worries me is that there could be a granted we have a big access capacity gap and normally you would say you cannot have inflation in that environment but if the monetary stimulus is great enough or it looks like it could be great enough, people start worrying about governments inflating away the debt.

You could get into a self-fulfilling kind of spiral of inflationary expectations and a couple of references were made to that today that it is very difficult to get a real handle on people’s thinking and what their expectations will be.