BoP, inflation and growth prospects for 2012-13

In its latest review of the Indian economy, the Prime Minister's Economic Advisory Council has expressed serious concerns about the deficit on current account which, in the current year, is likely to be of the order of the 3.6% of GDP – significantly more than the crisis year of 1991. The EAC would like the deficit to be below 2.5%. Surely, this will require a far better managed exchange rate, moving away from the floating rate regime we seem to have adopted during the last few years.

Turning to inflation, after expressing concern about the very high rates of inflation experienced in the last couple of years, the EAC claims that "Monetary policy has played a key role in the stabilization of prices over the past one year." Elsewhere, the report acknowledges that "The normalization of inflation in the current year has to a great extent been driven by easing of prices of primary food articles, especially of food grains, vegetables and fruit" and by "non-revision of diesel prices". Even the "believers" would not argue that either of these are the result of monetary policy.

The report also blames inflation for the falling domestic investment in recent years, and for growth in consumption. It hopes that "with a return of price stability … it is possible to visualize an improvement in the investment rate"; and that "price stability will also normalize consumption demand". One has reservations about the arguments as advanced. If consumption has gone up because the consumer is pre-poning purchases, the same logic would suggest that inflation may well expedite investments rather than delaying them. Is it not more likely that consumption has gone up and savings down because of the continued appreciation in the currency in real terms until recently? It is well accepted by now that an undervalued currency increases savings while an overvalued one has the opposite effect.

But this apart, whether we could see price stability in 2012-13 is debatable. The recommendations/suggestions in the report to reduce the fiscal deficit include "adjustments to the selling prices of refined petroleum products"; cut in the subsidy bill which "reduces the resources …. available for development expenditure"; "the electricity tariffs …. overdue for resetting"; etc). Again, the long-postponed upward revision of railway fares may well become unavoidable this year. All these would surely increase prices and therefore inflation? Globally, oil prices are shooting up by the day given the possibility of an attack on Iran, and these too would add to inflation pressures. And, in the current conditions, it would be risky to look at the exchange rate as an anti-inflationary tool to limit the domestic cost of imported crude, given the already huge deficit on current account, and the poor quality of our reserves. (Perhaps it is inadvisable even otherwise.)

Coming back to inflation and growth, our central bank seems to have arrived at a conclusion that WPI inflation in excess of a threshold of something like 5.5% reduces GDP growth, as witness various research papers including two in September 2011. This conclusion is also debatable. Is it the increase in WPI inflation beyond 5.5% that hurts growth – or are there other explanations for the correlation? For example, higher inflation may well lead to currency appreciation and therefore a larger negative number for net exports. Again, do the anti-inflationary monetary steps not hurt growth? What about fiscal deficits? (One of the studies acknowledges these factors but does not use them in its empirical analysis.) Too many accept without questioning that anti-inflationary policies are always virtuous, because inflation is a regressive tax; because inflation hurts the poor most. True, but surely lower than optimum growth (and hence job creation) hurts the poor even more! As Nobel Laureate Paul Krugman recently argued in his column in the New York Times, it is wrong to assume that "inflation is always harmful and always gets out of control". The worry is that the concept of a thresh-hold inflation rate may become a self-fulfilling prophecy because of the corollaries it generates!

But to come back to the prospects for 2012-13, would steps to correct the macroeconomic balance – fiscal, current account, and inflation – and some economic reforms, considered as synonymous with liberalisation, be enough to reverse the growth spiraling down? These are necessary conditions but will they be sufficient? Or will the economy suffer the same fate as our cricket team – from world champions to down in the doldrums in 10 months? I would not rule out the spectre given the poor, and worsening, quality of governance: political, administrative and judicial; the break-down of trust and communication between the political parties, between the centre and the states, and, equally, between the governors and the governed. Add to this the populism which has brought major segments of the economy's infrastructure – power and railways, for example – close to ruin; the way environmental concerns are inhibiting investment; etc. A happy new fiscal year seems difficult to visualize. But the cricket team did register a miraculous win last Tuesday. Will the economy? Keep the fingers crossed!

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