The Other Side June 6, 2013

Slow growth and Exchange rate

Last week's GDP number was generally disappointing and the news since then has hardly been encouraging – HSBC's Purchasing Managers' Index slipped to a 50-month low in May. The GDP data suggest, first, low manufacturing growth in fiscal 2012-13; and, second, inventory accumulation: the latter may also affect manufacturing growth in the current year. While the Q4 growth was slightly higher than Q3, it is not surprising that the country's Chief Statistician has cautioned that *"it is too early to say that growth will start to pick up.*" Apart from anything else, infrastructure paucity would continue to hinder manufacturing growth -- land, water, power, roads, etc. As for power, the following comment from the interview of Anil Sardana, Managing Director of Tata Power, published in this paper on June 1st, is telling: "*What can one do when several of your projects are yet to see any real movement because of procedural issues?"*

Overall, manufacturing growth is the weakest part of the Indian story: its contribution to GDP has remained stagnant for three decades. And, every fast growing economy over the last 70 years – from Germany and Japan in the post-war years to Asian tigers, to China now – has done so on the basis of a rapid increase in manufacturing output.

What we need is not just any kind of manufacturing growth but a continued increase in labour intensive manufacture. One Bureau of Labour Statistics report suggests that barely 5 mn were directly employed as production workers in the organized manufacturing sector in 2007-08, little changed over a decade! This is a pathetic number by any standard. Just about 2 mn jobs were created in the entire 11th Plan period – when there are something like 15 mn annual entrants to the job market! The recent annual World of Work Report from the International Labour Organisation sees rising risk of social unrest in South Asia "*as fewer people see opportunities for obtaining a good job and improving their standard of living"*.

Apart from manufacturing slowdown, another major contributor to the disappointing GDP number is the external sector: negative net exports in 2012-13 were of the order of 7.7% of GDP (expenditure based, current prices). I find it difficult therefore to agree with the arguments made by Swaminathan Aiyar in his column in the Times of India (June 2nd). The title is "Big trade deficit with China? Excellent!" (It is of course possible that the title was given by some editor/sub-editor to suit pagination, and not by Aiyar himself.) The trade gap with China in 2012-13 was Rs. 220,000 crores or $ 40 bn at the average exchange rate during the year. Aiyar's argument is that "*the deficit represents the gap in productivity between the two countries, especially in manufacturing"*. On first principles, cross-border comparisons need to be made by measuring productivity (or value added per hour of labour input) in a common currency. Measured in this way, if our manufacturing is far less productive than China's, surely the exchange rate has something to do with it? Even the famously high manufacturing productivity of Japan had become uncompetitive at JPY 76 to a dollar!

A recent feature in The Economic Times (May 21st) analysed the bilateral trade with China. Two conclusions it came to:

⇨ "India exports mostly low value added goods or commodities"; and
⇨ India mostly imports "what it should (can?) manufacture here".

This was exactly the pattern of trade between Britain and its colonies, in the days of the Empire!

On the issue of the exchange rate, I am reminded of Warren Buffett: he once described derivatives as "financial weapons of mass destruction", a description with which many Indian companies would agree. I think that an even more potent financial weapon of developing country destruction is the IMF's (and, surprisingly, G-20's) preference for free capital flows and floating, market-determined exchange rates. Too many countries have suffered major financial crises by listening to IMF's advice on the issue – from Mexico in 1994-95 to East Asia to Brazil to Argentina to ………. As for India, in its February 2013 report, the IMF has argued that

- "*A current account deficit of 3-3.5% of GDP is broadly consistent with India's relatively high growth*". But China and many other Asian countries have a higher growth rate and run current account surpluses;
- *"The projected 2012 CAD of 4% of GDP corresponds to a cyclically adjusted CAD of 2.7% of GDP, implying a current account gap of 0.7% of GDP ….. the real exchange rate is **undervalued** by 3.5-4.5% if the current account gap is to be closed only through real effective exchange rate (REER) adjustment*" Gobbledygook?

By my estimate, the exchange rate against the dollar needs to be over Rs. 70 to restore the tradeable sector competitiveness. (Incidentally, in my view the REER model used by RBI is not a reasonable measure of competitiveness). I found that two US academics (Ashoka Mody from Woodraw Wilson School, Princeton University, and Michael Walton from Kennedy School, Harvard University) have come to the same number: "*since early 2009, although the accumulated price differential relative to the United States has grown to about 35%, the exchange rate has depreciated by only around 10%, creating an appreciation of about 25%*" (Business Standard, May 7). Growth and job creation will remain far below potential if net negative exports continue to eat up 5%+ of GDP!

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