The Other Side

September 11, 2014

One Year and a Hundred Days

Coincidentally, the Governor's completion of one year in office, and the National Democratic Alliance's 100 days, occurred more or less together. The media has made extensive comments and analysis of both in the last few weeks: far more laudatory to the former, more mixed to the latter. (To be sure, business leaders have almost uniformly praised the government: they generally laud whoever is in power, but vote with their feet, investing in India if the climate is favourable; abroad if not!)

First the 100 days. While there has been little progress on policy issues like better directed subsidies (40% go to the better off today as per a World Bank estimate), land acquisition for industry or infrastructure, closure of non-performing public sector undertakings, etc., some things do seem to have improved: regulatory approvals are faster; *babus* are coming on time and working harder.

The other side is that the Jana Dhan Yojana, under which 15 mn accounts were opened on day one, in over 75,000 camps (200 per camp), seems to have been launched without adequate preparation: will the end result be any better than the "loan *melas*" conducted when the senior Mrs. Gandhi was in power, which resulted in large non-performing assets? Will the credit cards and overdrafts under the Jana Dhan Yojana suffer the same fate? With Jana Dhan, has *Aadhar* once again become *Niradhar*? Is "financial inclusion" a corollary of economic growth and higher per capita incomes, or vice versa: which is the dependent variable?

Turning now to the Governor, he has had extensive coverage in the media on completion of his one year – full page interviews, lunches with Tamal Bandopadhyaya of this paper, and James Crabtree of the Financial Times, etc. etc. Most have been extremely laudatory, praising the way he handled the mini-crisis in the exchange market immediately after taking charge; his modesty and superb articulation; his calm and confident persona – and I agree with all the praise showered on him. Professionally, the best thing about him is that, despite coming from Chicago, he obviously does not subscribe to the market fundamentalist "Chicago School" of economists (sometimes also referred to as fresh-water economists as distinct from the salt-water (more Keynesian) economists in New York). To give one example, I can do no better than quoting him from an article by Victor Mallet (Financial Times, August 8, 2014): "*there is the age-old mantra 'let the exchange rate do the talking as then you are insulated' …. That advice is garba ge*": the *mantra* is part of the International Monetary Fund ideology!

Under him, the central bank has been far more active in the foreign exchange market, differing significantly from the policy under his predecessor: this is also reflected in the sharp rise in the reserves over the last one year (from $ 275 billion to $ 319 billion): in my view, reserves of foreign exchange, whether of India or China or any other country, are more a corollary of the exchange rate policy, and not so much an independent variable to be targeted. Indeed, if exchange rates are to be fully and always market determined, there is no need for a central bank to have reserves! The stability around Rs. 60 per dollar over the last one year is surely the result of deliberate policy on the part of the central bank, backed by intervention, and hence the rise in reserves.

The other side is that nominal stability means continued appreciation in "real", i.e. inflation adjusted, terms. And, this certainly erodes further the competitiveness of the tradeables sector of the economy: the merchandise trade deficit in the first quarter of the current fiscal year was $ 35 bn, despite lower oil prices. The implication is that output (and employment) loss in this sector is as high as 7% of GDP! Another manifestation of the overvaluation is that corporates continue to prefer foreign currency loans to INR debt – though the former is a scarcer resource than the latter, and should cost more!

In a full page interview in the Times of India (August 31, 2014), as elsewhere, the Governor has expressed concerns about the possibility of a flight of foreign portfolio capital from India, when US interest rates go up. To quote him, "*We have plenty of reserves, but I see reserves as a second or third line of defence…. The primary line of defence is we should be attractive.*" I offer two different perspectives:

- The effort should be to increase the attractiveness of India for the foreign direct investor, today caught up in a maze of regulations, tax disputes, etc.: no wonder, we have slipped 11 steps in the latest ranking of the World Economic Forum. It is FDI which creates output and jobs, not portfolio investment;

- Even more importantly, the domestic economy needs to be competitive enough not to depend on imported capital to balance the books. In my view, this means that the objective of the exchange rate policy needs to be a balanced current account, net of remittances, optimizing consumption and output.

As it is, the net **negative** international investment position, as a proportion of GDP, has gone up to 17%, one of the highest ratios in the world. It is worth emphasizing that every Asian economy which has grown fast has done so on the basis of a competitive exchange rate, helping rapid growth in the manufacturing sector – not by continued import of portfolio capital.

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