The Other Side February 12, 2015

“Maintaining Growth in India”

Dr. Raghuram Rajan recently wrote an article of the above title on the Project Syndicate website (“The world’s opinion page”). The article was obviously finalized before the recent changes in methodology and base year of growth calculations: this article argues the other side of Dr Rajan’s views.

He starts off by saying “*The global economy’s slowdown has not spared India. Sustaining the growth that it needs to continue to lift millions of people out of poverty will require rethinking its economic-policy approach*”. He also believes that “*Fueling growth through domestic demand will have to be carefully managed. As a country that does not belong to any power bloc, India cannot afford to put itself in the position of needing multilateral support – a trap into which even developed countries, like Portugal and Spain, have fallen*”. As I have argued in my last article, **the ever-increasing net external liabilities may well be leading us into that very “trap”.** His worry is the “*risk of overstimulation, with fiscal deficits fueling large current-account deficits*”. Are fiscal deficits the only, or even the principal, drivers of external deficits? Surely the real external value of the rupee has something to do with them, an issue on which he is silent. The argument seems to be that so long as the fiscal deficits (or government dis-savings) persist, savings will remain below the investment needs of the economy, and hence the external deficit.

While domestic savings as a percentage of GDP have been falling, the question is whether the external deficit (and the exchange rate) is determined by the savings investment imbalance, or does the exchange rate influence at least the savings side in the macro-economic identity? Which is the dependent variable? Arguably, the cause effect relationship runs from real exchange rate to savings:

⇒ It affects the competitiveness of the tradeables sector. Indian producers are unable to face Chinese competition in sectors as diverse as paper, steel, electrical goods and fittings, power plants, mobile phone assembly, etc. The resultant pressure on the top and bottom times reduces corporate savings and government revenues in the form of both direct and indirect taxes: the Q3 corporate results speak for themselves. Even the information technology sector has started experiencing pressure on margin because of the exchange rate.

⇒ Personal savings are also not immune to the real exchange rate. Overvalued exchange rates increase the propensity to consume cheaper imported goods; encourage foreign travel; and tempt more people to remit funds abroad.

Clearly, the real exchange rate is important for the external sector but the article does not touch upon it. And, since the end of 2013, the rupee has appreciated in real terms, against the currencies of all major economies, even more than the USD and CNY.

To come back to Dr. Rajan's article "*the Reserve Bank of India should focus on keeping inflation low and stable, ensuring optimal conditions for growth*". Is this single-minded focus warranted? Does any increase necessarily lead to hyperinflation and a loss of confidence in the domestic currency? And, what is the definition of hyperinflation: 10% p.a.? 20% p.a.? South Korea had 20% inflation during the years of its miracle growth. And, in the last 30 years of "great moderation" (i.e. low inflation), the growth rate in the US has been much lower than in the earlier, higher inflation 40 years, even as income inequality has increased sharply.

Dr. Rajan further argues in the article that "*India will run a current-account deficit for the foreseeable future*": yes, it will, if the exchange rate remains overvalued in real terms. Incidentally, the deficit number underestimates the loss in potential output, employment and growth: inward remittances equal to 4% of GDP are not really part of our "output".

Dr. Rajan believes emerging economies should press for "*new agendas, new ideas, and new thinking into the global arena*". Two suggestions

⇒ Inflation, demographics, and the inadequacies of the standard dynamic stochastic general equilibrium (DSGE) model of the macro-economy; and

⇒ The importance of managing the exchange rate for emerging economies.

Regrettably, he is silent on both issues.

Credit Rating Agencies

Earlier this month, Standard and Poor's agreed to pay $ 1.4 bn to settle claims of the US federal and state governments, arising from the rating practices in the US mortgage backed securities market which led to the 2008 financial crisis. Thousands of such securities were given AAA ratings to earn fees and increase S&P's market share. (In other words, ratings were "bought" by the issuers.) The rating professionals knew about the credit risks, but these were not properly reflected in the ratings. The authorities are now stepping up enquiries in the other major rating agency: Moody's.

Are such malpractices prevalent in India as well? To recall a personal experience, many years back, I had been given a professional assignment to prepare an asset liability management policy for a housing finance company. Before I even began working on it, the assignment was cancelled, and given to one of the rating agencies, who do a considerable amount of consulting work for clients: it seems the housing finance company had also simultaneously requested for a credit rating from the same agency. I have often wondered whether there was a connection.

The best way of mitigating the problem is for regulators to prescribe that the rating committee should comprise of independent professionals (not company employees), who have no business responsibilities.

A.V.Rajwade

Email: avrajwade@gmail.com