

### **BoP: Problem of Liquidity or Structural?**

Our political masters are fond of blaming the global slowdown and the crisis in Europe for our slower growth and the fall of the rupee over the last 12 months. These reactions remind me of what John Kenneth Galbraith wrote about the October 1929 stock market crash in his *Short History of Financial Euphoria*: *"The market in October 1929 was said to be reflecting external influences ... Professional economists were especially cooperative in advancing and defending this illusion."*

Two major documents/data from the central bank have been released over the last couple of weeks: the Financial Stability Report, and the balance of payments data for fiscal 2011-12. The former acknowledges that *"All the key external sector vulnerability indicators - the reserve cover of imports, the ratio of short-term debt to total external debt, the ratio of foreign exchange reserves to total debt, the debt service ratio and NIIP-GDP ratio - deteriorated"*. It also points at global uncertainties *"leading to increased risks in financing the external deficit"*, and hopes that the administrative measures taken to encourage capital inflows and fiscal consolidation could help moderate the risks. In fact, the tone and content, in particular the absence of any comments at all on the exchange rate policy, make one wonder whether the policy makers continue to look at the problem as being one of liquidity; of the primary cause being the savings investment imbalance created by the quality and quantity of the fiscal deficit; and nothing to do with the changed exchange rate policy of the last few years. If so, perhaps only a major crisis will open our eyes: some macro numbers in 2011-12 --- fiscal and current accounts deficits as a percentage of GDP – are worse than in 1991.

Prof. Kishore Mahbubani argued in an article in the Financial Times (February 8, 2012), that western capitalism is in crisis as a result of three mistakes. The first is the belief that market-determined prices are always more rational than policy makers' conscious choices. *"Alan Greenspan was probably the greatest victim of the ideological conviction*

*that markets always knew best, so there was no need to regulate them vigorously. This has wreaked havoc on the world. Yet no Asian society fell prey to this dogma. Instead, they believe that no society can prosper without good governance.”*

We still seem, however, to believe in the rationality and efficiency of the market, that the market determined, highly volatile external value of the currency is a better policy. I find such market fundamentalism curious and representative of an ideology which says that the domestic value of the currency must be kept stable (in order to protect the purchasing power of the savings of the rich?), but a highly volatile external value is better (because it creates another “asset class” for the rich to make speculative profits?). For this ideology, the impact of the external value on the competitiveness of the tradeables sector, on growth and job creation, etc are of no concern; the solution to deficits is to attract ever more capital from abroad. If that does not work, a crisis will result, businesses will close, output fall, and unemployment increase sharply (ask the Mexicans in 1994-95, east Asians 1997-98, Brazilians in 1998, Argentineans in 2001, and Greeks and Portuguese now) – and the economy will stabilize at a lower level of output. This, after all, is the process of “creative destruction” in capitalism. It would be truly amazing if our policy makers, who are getting more and more nostalgic about the politics of distribution (not production) we practiced under the senior Mrs Gandhi, are really convinced that this is the right policy for us!

There is a huge discrepancy between our BoP/GDP data. My analysis suggests that in 2009-10 and 2010- 11, the **negative** contribution of net exports was around Rs 50,000 crores **less** in the GDP data than the number in the BoP data (goods and services). The gap has jumped to Rs. 120,000 crores in 2011-12., with Q4 reporting a **positive contribution of net exports to GDP!**

What about the second point made by Prof. Mahbubani: governance? If I were to really say what I feel on this, my editor will not permit either the additional words – or my language! But I can’t resist making one observation: whatever our conflicts, rivalries and differences with our neighbour on the North West, we have a common culture of

sloppiness in governance. On the same day that reports suggested that the Mantralaya in Mumbai had violated all fire safety rules, came the report that the name of the Indian prisoner given presidential pardon in Pakistan had been wrong in the first official announcement!

Let me end by quoting Prof. Jagdish Bhagwati and Prof. Arvind Panagaria (letter to Financial Times, June 5<sup>th</sup>, not TIME cover story or Obama's comments or those of the Singapore Prime Minister) *"there is a policy paralysis, which began with the environment minister denying clearance to many projects nationwide. More importantly, this was reinforced by virtually every central ministry freezing up prudentially in response to an outbreak of corruption scandals."*

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