**UPA II's Third Anniversary**

The Prime Minister hosted a dinner earlier this week and released a report lauding the achievements of UPA II, to mark the anniversary. The other side is an out-of-control fiscal deficit; slowing growth; stubbornly high and rising inflation; a lack of job creation; and growing external imbalance. In fact, as the rupee keeps falling despite some central bank measures, for practically a year, I have started wondering whether we are heading for a BoP crisis and what, if anything, can be done to avoid it. It was amusing in this context to read a report (Business Standard, May 18) to the effect that the Finance Ministry is "pitching" for higher ratings from Fitch! Clearly, the way policy makers look at the situation and other analysts do, is as wide as it can be!

There are those who argue that the problem of capital inflows not adequate enough to balance the demand and supply in the market is a cyclical one, not a structural one, caused by the crisis in the euro zone. Official spokesmen also blame the global scenario and there seems to be considerable complacency on the issue. The thinking seems to be that we still have sufficient stocks of reserves to ride out any cyclical problem and, therefore, can continue to live beyond our means, incurring fiscal/current account deficits.

In reality, the problem seems to be structural, not cyclical, and the root causes domestic. Given the floating exchange rate policy we seem to have followed for the last few years, the rupee had appreciated significantly in nominal and, much more so, in real terms, between March 2009 and mid 2011, on top of a sharp earlier appreciation in 2007-08. An overvalued currency not only diminishes the competitiveness of the tradables sector of the economy, but also increases consumption thus reducing savings, both leading to higher deficits on the current account. (The external deficit also reduces GDP as compared to its potential at a reasonably competitive exchange rate.) No wonder, the current account deficit has widened from less than $ 10 bn in 2006-07 to perhaps $ 70 bn plus in 2011-12, and led to a sharp rise in the net external liabilities of the economy. (We will have to wait five weeks for the official data). While part of the reason could well be the rise in price of both crude oil and gold, there has also been a huge growth in manufacturing imports, another manifestation of the uncompetitiveness of the exchange rate.

Is putting restrictions on gold imports a solution? To my mind, the answer is in the negative: given our hunger for gold, this would merely drive gold imports and inward remittances into the illegal smuggling/hawala market, leaving the current account unaffected, as we experienced for 40 years.

Is larger and more determined RBI intervention a possible solution to the continued slide, on the assumption that, at the present exchange rate, the tradable sector is now more competitive in the global market and the deficit will correct itself in 2012-13. But exchange rate changes affect trade numbers with a lag. Again, lower gold and oil prices now prevailing may help, but services export growth is falling. Shutting of mines (coal and ore) would reduce exports and increase imports, Flip flops on agricultural exports (cotton and sugar) only damage our reputation as a reliable trading partner. Overall, it is difficult to be optimistic about an improvement in the current account in 2012-13

In any case, some stability in the exchange rate would be needed if discretionary capital inflows are to resume. However, if the problem is structural, as I believe it to be, then intervention to hold a level would merely waste reserves which are already less than the external borrowings. It would be meaningful only if it is accompanied by various macroeconomic and regulatory measures, including in particular the following:

⇒ A mid-year budget cutting the various subsidies and deficit sharply, not just cosmetic austerity measures announced by the Finance Minister; increasing domestic prices of petro-products may also help reduce consumption, waste, smuggling and imports;

⇒ Acceptance of a higher inflation for 2012-13;

⇒ Giving up the policy of a floating exchange rate and manage the real external value of the rupee in a manner suited for an economy producing non-differentiated goods and services, with the objective of bringing down the deficit to say 1% of GDP in 3 years: this would also need a more rational index model than the bilateral trade-weighted REER;

Much is also needed to be done on our FDI policy; GST; environmental regulation; tax laws; and infrastructure. Can we not do these things voluntarily instated of waiting for a crisis? We obviously can, but one is not very hopeful in the absence of a political/governmental leadership capable of "leading", i.e. articulating, arguing, convincing their partners and opponents of the logic of the proposals. Policy making has been reduced to the lowest common denominator – it is so comfortable to withdraw, to backtrack, to blame things on the coalition *dharma*, on global economy; etc.

A.V.Rajwade
Email: avrajwade@gmail.com