

### IMF's Report on India

The International Monetary Fund has recently forecasted that India would be the fastest growing economy in the world in 2015-16: the other side is that the IMF's forecasting record in the recent past has been poor (see The Other Side, November 20, 2014). (And our own revised GDP numbers are puzzling as there is little secondary data to support them.) Some specific points in the IMF's latest country report on India, released earlier this month, are discussed in the following paragraphs.

As for the banking system, *"The main risk is the weakness in corporate balance sheets (including a large exposure to rest of the world). Further corporate stress could emerge from a surge in global financial market volatility (affecting one of the main sources of funds for corporates), adding to banks' non-performing assets (NPAs)".* For one thing, non-availability of further foreign funding may affect future corporate growth, but not NPAs, at least directly. Again, the corporate sector's *"large exposure to rest of the world"* (read "external commercial borrowings", ECBs) would lead to "corporate stress" **if the exposures are unhedged and the rupee falls substantially**. The central bank which exercises tight control over ECBs, has been cautioning corporates against the risk of unhedged exposures, but it surely needs to introspect on two issues:

- ⇒ Its exchange rate policy (or lack of it) has ensured that unhedged ECB's are cheaper than rupee debt since the rupee's depreciation has been generally less than the interest/inflation differential; and
- ⇒ If corporates do want to hedge, **where will the supply come from with large deficits on both the flow and stock sides?**

In fact, the first issue has encouraged "carry trade" by both foreign portfolio investors in the Indian bond market, and Indian corporates with ECBs.

The IMF Report then repeats the usual homilies about the *“long-term negative effects on growth of persistently-high inflation”* and the virtues of *“fiscal consolidation”*, issues on which I have commented in my recent articles.

The Report believes that *“India’s international reserve levels are adequate to cover a broad set of risks”*. There is little analysis of **the quality, as distinct from quantity, of the reserves**. Surely reserves built from current account surpluses are qualitatively far superior than those increased through ever larger liabilities? Our “record” level of reserves has come through *“the inflow of about \$ 34 bn of non-resident Indian deposits and overseas borrowings by banks, facilitated by a concessional FX swap facility offered by the Reserve Bank of India (RBI)”* and *“robust foreign institutional investor (FII) inflows – FIIs have made about \$ 48 bn in net purchases of Indian equities and debt between September 2013 and December 2014.”* But the IMF is silent about the quality of the reserves, its certification of adequacy being based purely on quantitative econometric models; there is no analysis of what would happen “when the music stops”. (But then this should not surprise us: the IMF’s global financial stability reports did not forecast the 2008 financial crisis in its backyard).

At one place, it refers to *“cost to holding reserves as they yield a lower return than other assets in the economy”* – but nowhere to the “cost” of lost output and employment resulting from persistent external deficits. (This is actually much more than the current account deficits because of our “Dutch Disease”: inward remittances). As for the deficit itself, the *“staff assesses that a smaller CAD of about 2 ½ % of GDP is a more appropriate norm. This level is higher than the estimated underlying CAD of about 2% of GDP in FY 2014-15. The CA gap is therefore estimated to be in a range of -1 to +1 % of GDP.”* I, for one, am unable to understand what is the message from the three sentences read together. Again, 2.5% of GDP is stated to be a *“more appropriate norm”*: forever?

The Report acknowledges that India’s net international investment position has deteriorated to –17% of GDP: no comments about its sustainability, or comparisons with other countries. (As it happens, it is one of the highest in the world!)

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There is an old saying in Sanskrit to the effect that one should pay tribute to the rising (not setting) sun. In the global economy in the 21<sup>st</sup> century, the dominant power is likely to be China – as the US was in the 20<sup>th</sup> and Britain in the 19<sup>th</sup>. At this stage of our development, we have more to learn from Beijing/Shanghai than the Washington/Wall Street/IMF axis: in terms of growth and infrastructure development; management of the external account; job creation in labour intensive manufacturing; etc.

In his March 4 statement announcing the last rate cut, Governor Rajan claimed that *“disinflation is evolving along the path set out by the Reserve Bank in January 2014 and, in fact, at a faster pace than earlier envisaged.”* Has this been helped by *“an excessively strong rupee,”* which *“creates disinflationary impulses”*? The RBI’s own six country real effective exchange rate index evidences 25% overvaluation (base 2004-05)! One example of its cost: *“Two world-beating companies that make labour intensive products are headed by Indians. Neither uses India as a significant export base.”* (Rahul Jacob in Business Standard, March 19. He is referring to Ramesh Tainwala of Samsonite and Ranjan Mahtani of Epic Group.) Surely the exchange rate has something to do with this? No wonder T.N.Ninan asks *“What’s RBI smoking?”* (Business Standard, March 21<sup>st</sup>).

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