The Other Side September 27, 2012

So far so good

Last week, the government announced some administrative measures (FDI in retail, increase in price of diesel and LPG, drop in withholding tax on external borrowings, disinvestment, etc.). Reports convey that further changes are expected through an increase in ceiling on external commercial borrowings, and liberalizing norms, easing of curbs on portfolio portfolios, etc. While I would not glorify the changes by calling them “reforms”, both the stock and currency markets have reacted very “positively”. The share market has zoom in rupee terms and even more so in dollar terms.

All these changes are to be welcomed – indeed, clearance to FDI in retail and lower subsidy on diesel has been overdue for a very long time. What has prompted the changes now, and will they do much to increase investments in domestic economy and the growth rate? In fact, the more I think about it, the more I am convinced that the changes have been driven more by the anxieties about the external deficit and how to finance it rather than anything else. Consider the evidence:

⇒ FDI in retail, another source of external funds;

⇒ Reduction in fuel subsidy, to stave off a possible downgrade of the country’ rating which would make it even more difficult to attract capital from abroad;

⇒ The cut in the withholding tax on ECBs, the expected increase in the ceiling and easing of curbs on external portfolio investments once again aim at the same objective;

⇒ The number of references (at least flour by my count) in the Prime Minister’s speech to the nation.

Whether the way to tackle the mounting net external liabilities of the country ($ 250 bn on last count) is to pile on even bigger debt, is of course a very debatable proposition). If genuine reform was the objective, the government should have done something to make the tradable sector of the economy more competitive with world markets through a far better managed exchange rate policy. One wonders of course whether the change in policy in the last few years, a topic on which I have commented extensively in the past, was driven by the former CEA. This would be no surprise at least to this columnist: I find that the American milieu in which economist there have worked and studied is not very conducive to appreciating the needs of an economy like India's. First, the U.S. has the "extraordinary privilege" of having its domestic currency as the world's reserve currency; second, as one former U.S. Treasury Secretary claimed, "the dollar may be our currency but it is the world's problem". Unfortunately, the rupee's external value and the external imbalance is our, not the world's, problem. Will the new CEA take a look at the issue from first principles?

While on the subject of the exchange rate, I am often sadly surprised at the woeful illiteracy of too many Indian business leaders on the subject of the exchange rate – or, indeed, of the real interest rate. As for the former, while they keep lobbying endlessly or changes in duties, some procedural simplifications on trade, etc. Few lobby for a proper exchange rate which would make them competitive. Again, few seem to appreciate that a rising rupee is as deflationary as rising interest rates. In a way, the recent calls by business leaders for lower interest rates are amusing – as the RBI's Annual Report shows, real interest rates have been negative in recent years, when growth has been falling, and were positive in earlier years when growth was strong!

To my mind, the real problem of falling growth is not so much interest rates but the appreciating currency on the one hand and the quality and quantity of the fiscal deficit on the other. As for the later, capital expenditure was roughly a quarter of government expenditure in 2003-04, and barely half of that in 2011-12, even as subsides, which absorb 9.4% of the expenditure in the earlier year, have gone up to 16.4% in the last fiscal year. (I owe these very insightful numbers to Manas Chakravarty's column in Monday's Mint.) These are of course the consequences of the top down model of social welfare, so favourite of the only really powerful in the government. (Incidentally, the man who made the biggest lasting difference to far more millions than all the programs named after various members of the Gandhi family, through a bottom up model of development, namely Verghese Kurien, died recently. RIP.)

Talking about the recent changes in an interview, Ashwini Kumar, Minister of State, Planning, was quoted as saying that “we need to engage with the people and convince them bad economics can never be good politics, in the long run” (Economic Times, September 19, 2012). One wonders whether he does not need to start with convincing his own party’s supreme leader that 8/9% growth is essential for the social programs she is committed to; that for this both the quality and quantity of fiscal deficits needs to improve. One also suspects that many of his party colleagues are still committed to the “bad economics” of Indira Gandhi’s “socialism”.

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