

### **“Make in India” and the Exchange Rate**

In my last article, I had argued that, while the focus of the Finance Minister (and rating companies) is on containing the fiscal deficit, the actual outstanding government borrowings as a percentage of nominal GDP have been falling for some time; also that the conventional fiscal accounting ignores Government of India's assets. In other words, the domestic currency balance sheet of the government is quite strong and provides room, in the forthcoming budget, for a major thrust on infrastructure investment.

The other side is that the economy's foreign currency balance sheet is far weaker, but few macro-economists, media commentators, and indeed policy makers seem to be concerned about it: the quarterly International Investment Position (IIP) report hardly receives any attention from the media – or even policymakers. Recently, the Finance Minister commented that the larger deficit on current account in Q2 of fiscal 2014-15 is not something he is worried about, given the level of our reserves. And, the latest Financial Stability Report of the Reserve bank has barely two innocuous paragraphs on the developments in the external sector.

The IIP report released at the end of last month, gives data as on 30<sup>th</sup> September 2014. It shows that our international assets, **including the reserves**, were \$ 488.5 bn; the liabilities on that date were \$ 842.1 bn: in other words, **the net IIP was a negative \$ 353.7 bn, an increase of more than \$ 50 bn in just one year**, from September 2013 to September 2014. In other words, **the economy's foreign currency balance sheet had a negative net worth of the order of \$ 350 bn or say 18% of GDP**, evidencing a sharp increase from 5.1% at the end of 2008-09! Again, when I tried to reconcile the flow data from the balance of payments report for Q2 of fiscal 2014-15, with the stock data in IIP and India's external debt report, as on 30<sup>th</sup> September, I found major discrepancies. (One suggestion to whoever compiles the reports: it will be useful if identical nomenclature is used in all three reports.)

At one time, the norm was that reserves are considered adequate if they can cover six months imports; by this conventional yardstick our reserves are adequate. However, in an era of liberal capital flows, in my view, to look at reserves in relation to imports alone would

be less than prudent. The potential demand on the reserves is not only payments for current imports, but also the possibility of non-rollover of short term credits of \$ 86 bn, in the event of a problem. Portfolio investment in India at the end of September 2014 was \$ 205 bn in equity and debt securities together. Media reports suggest that most funds are over-balanced in their exposure to India. No wonder: they have made large profits on their investments in India over the last year. The exchange rate is back to where it was at the end of 2013, in fact, a little higher; the SENSEX has gone up 40% since then; also, over the period, bond yields have fallen by more than 1% and the investor in say a 10-year bond would have gained perhaps 7% in a year on price change, over and above the coupon: the gains are much higher if the investor is undertaking a leveraged “carry trade”, shorting the dollar and going long on the rupee, on an unhedged basis. While equities have gone up sharply since the surprise rate cut of a quarter percent a couple of weeks back, perhaps the biggest beneficiaries have been foreign portfolio investors. We should not forget that portfolio investments can come in quickly; *but they can as well go out when things change: nor should we overlook the herd instinct among portfolio investors.*

There is one other aspect of the external scenario which we seem to often lose sight of: a **deficit on trade account represents lost output, employment creation and growth** for the economy. In other words, in the focus on financing the deficit, we should not be losing sight of the output loss which the deficit represents.

Our Prime Minister has recently emphasized that “Make in India” needs to be achieved by “mass production by the masses”, and that “development has to result in job creation”: actually, the latest industrial employment survey (2012-13) reports that employment fell 4% in that year, at a time when something like 20 mn Indians are entering the job market each year: my estimate is based on the fact that a 100 mn voters were added to the list between the 2009 and 2014 elections. Our share of global exports has been falling since 2011. What we need is a sharp rise in labour-intensive manufacturing for both domestic and global markets. And, for this, an important facilitator is a competitive exchange rate. One was hoping that, taking advantage of the fall in global commodity prices and inflation, our policymakers would use this opportunity to depreciate the rupee to a competitive level, but obviously this has not happened at least so far. In fact, over the last one year, the rupee has

strengthened, even in nominal terms, not only against the euro and yen, but also against the dollar and the yuan! Can persistent external deficits, and ever increasing net external liabilities, be counted on to increase growth? We obviously need a far stronger foreign currency balance sheet.

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