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India squeezed by financial repression

By Kunal Kumar Kundu

NEW DELHI - The least desirable outcome of the recently presented union budget of India was a complete undermining of the sanctity of the budget numbers. As was explained by me earlier, the cash strapped government had and continues to adopt various dubious means of keeping its official fiscal deficit number under check while continuing to spend its scarce resources on leaky social sector programs. (See Chidambaram shows dangerous budget skillsAsia Times Online, March 4, 2013). Funding expenditures of such magnitude in the face of revenue scarcity leads to what is called financial repression.

The term financial repression was introduced in 1973 by Stanford economists Edward S Shaw and Ronald I McKinnon. It was meant to include such measures as directed lending to the government, caps on interest rates, regulation of capital movement between countries and a tighter association between government and banks. In layman's term, it refers to the means by which the government expropriates savings of ordinary people or corporations. Clearly financial repression is a key ally of profligate governments.

In its crudest form, financial repression was visible in the recent budget exercise by Finance Minister P Chidambaram, which was resorted to to enable the government to show a lower fiscal deficit and, thereby impress the credit rating agencies.

The state-owned oil companies were forced to bear 40% of the total calculated oil subsidies, and even the remaining amount that is to be paid by the government is done so with an inordinate delay which will force the oil companies to go on a borrowing spree for sheer survival. This flexing of muscles by the government not only reduces its borrowing requirement but also provides some relief in its debt servicing requirement.

All of this, for a policy that:

- Destroyed private competition (since subsidies are available only to the state-owned companies and hence private sector retailing of petrol, diesel and even cooking gas did not take off as the private companies were not in a position to sale their products at less than the cost price, which the state-owned companies did;
- Is enjoyed mostly by the rich, as reported in an International Monetary Fund study. Even the government's recently released annual economic survey believes that more than half of rural rich

corner almost the entire cooking gas subsidy, leaving practically nothing for the poor for whom it is earmarked.

Given the government's mindless spending on such schemes, many with questionable benefits, the government's borrowing requirements remain elevated. However, not much of the borrowing is done from lenders who are willing to lend. In fact, a good chunk of government bond issuance is forcibly placed with various financial entities. These include banks, insurance companies and pension funds.

Banks, for example, are forced to set aside 23% of their deposits in government bonds as statutory liquidity ratio as part of what is called prudential management. That apart, they have to maintain 4% (it was higher earlier) of their deposits as cash reserve ratio, on which the government has stopped paying any interest whatsoever since March 31, 2007. In all, the banking sector has to keep 27% of their deposits with the government.

The pension system operated by the Employee Provident Fund Organization (EPFO) is almost entirely invested in domestic government bonds. That apart, of the 12.11 trillion rupees (US$222 billion) invested by life insurance companies on March 31, 2012, 38.64% was invested in central government securities; a further 17.71% was invested in state government and other approved securities.

The Indian financial policy, therefore, ensures that the government gets roughly all EPFO assets, more than half of the assets of life insurance companies and more than a quarter of the assets of banks.

Not that financial repression is new in India. In fact, this is true for all developing economies. For a capital-scarce country like India, capital control was a natural outcome, since the idea was to direct savings toward investment in certain targeted sectors as part of a development plan.

Financial repression took the form of government's ownership of intermediaries, restrictions on interest rates, control of foreign exchange (especially outflow), credit schemes that are favorable to a few sectors and so forth. Regulation also stipulated (and this continues to be the case) that the banks hold a large share of their assets in public debt instruments. These debt instruments paid below-market rate interest and hence imposed an implicit tax on financial intermediation while providing cheap source of capital to the government.

Unfortunately, for India, the requirement to follow such policies has transcended the need to address various development objectives; it is now being resorted to simply because governments of various hues have failed to adhere to fiscal discipline. I believe that the fiscal deficit is but a natural consequence for a capital scarce developing economy like India that strives to move to a path of high and sustainable growth. The problem lies with the quality of the deficit, as wasteful expenditures and politically motivated populist measures contaminate the nature of the deficit, thereby leaving very little fiscal space to carry out the developmental activities.

Thus disinvestment efforts by the government are being bailed out by state-owned institutions like the State Bank of India and the Life Insurance Corporation of India (LICI). The government has arm-twisted the Insurance Regulatory Development Authority to allow LICI to exceed the cap of 10% that an insurance company can own in any listed company.

Even the cash rich state-owned companies are being made to use their funds to buy stakes in other companies whose shares the government plans to sell, irrespective of whether such acquisitions make sense for the acquiring companies. Without such support, the government's disinvestment program during the fiscal year 2012-13 would have been an utter failure.

What is even more galling is that, while the government's wasteful expenditure is on the rise, it is way behind other countries (even many poorer countries) in terms of the share of gross domestic product spent on health and education - higher spending on which is essential if India is to reap the demographic dividend of its young population.

So the government has, very recently, mandated that corporate entities with a net profit of 50 million rupees and turnover of 10 billion rupees should mandatorily spend 2% of their net profit on acts of "Corporate Social Responsibility" - a perfect example of how a government forces private sector entities to fill in the void created by their inability.

To conclude, financial repression engendered by systemic inefficiency has the potential to distort savings and investment activity in the economy and eventually impact growth. It's time India learned from the Chinese experience and finally showed the courage to take appropriate policy measures to right the wrong. However, given the way the political circus playing out in the country, that is a long shot.

Kunal Kumar Kundu *is a New Delhi-based economist.*