

South Asia

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India's top banker faces enemy within

By Kunal Kumar Kundu

Even if you were a Sachin Tendulkar - a cricketer without peer when in his pomp - you would still have nightmares if in your debut match you had to face the likes of bowlers Lillee, Akram, Garner and Holding at their rampaging best and on a sticky wicket.

So might Raghuram Rajan, an accomplished economist (though without administrative experience), have a few nervous moments in taking over the governorship of India's central bank, the Reserve Bank of India (RBI), with the economy rapidly slowing and facing frontal attack on several fronts - high twin deficits, high inflation expectations, and of course a currency that is weakening faster than your heart can beat.

It will surely be a baptism by fire for Rajan as he prepares to replace outgoing RBI governor Duvvuri Subbarao early next month. His career so far has ticked all the right boxes - rising from being a young professor to becoming chief economist at the International Monetary Fund, India's Chief Economic Advisor and now one of the youngest RBI governors.

An important landmark came in 2005, when at a celebration honoring the imminent retirement of the then US Federal Reserve chairman Alan Greenspan, he presented the paper, "Has Financial Development Made the World Riskier?" When the financial crisis erupted toward end 2008, his credibility went up several notches. However, during the intervening period he was soundly berated by the intelligentsia, and his views were dismissed as sheer naivety. Clearly he knows a thing or two about the economy, the working of the financial world and of policy making. As an outsider, he can also bring in a fresh perspective. To that extent, his is the right choice.

But can he deliver? I have my doubts. Even he betrayed some sense of apprehension as, immediately after the appointment, he said that he does not have a magic wand to solve the problems plaguing India's economy. Indeed he does not have one. But for an economist who exhibited an ability to predict a crisis, a bigger question is whether he has the ability to manage a crisis as well?

The present RBI governor will walk into the sunset with his credibility generally intact, but his tenure is marked by two major policy mistakes. First, Subbarao allowed monetary policy to remain accommodative for a fairly long period during 2009-10 having failed to sense the precise trajectory of future inflationary pressure. When he got the inflationary trajectory right, he was willing to take on the Ministry of Finance and decided to sacrifice growth for the sake of controlling inflation.

However, Subbarao got it wrong a second time when he decided to defend the rupee at all; having become an inflation crusader, he was worried about the inflationary impact of a weak currency, especially for a country that is a large importer of oil.

But is the rupee defensible under 60 to the US dollar? Certainly not. India's real inflation is much higher than the official gauge (the Wholesale Price Index) depicts. Inflation as gauged by the Consumer Price Index or calculated by the gross domestic product (GDP) deflator method is high.

Policy inertia and stalled investments have resulted in falling productivity and hence a loss competitiveness, which is reflected in a high and rising current account deficit (CAD). At 4.8% of GDP, India's CAD is nearly double the rate that can be sustained for a long time. Unrestrained social sector spending (not matched by revenue generation) has meanwhile resulted in a high fiscal deficit.

Clearly, whichever way one looks at it, the rupee should be trading at around 62 to the dollar. However, outgoing governor Subbarao seemed to have staked his reputation on targeting the rupee at between 58 and 59 to the dollar by sucking up liquidity through various measures, vigorously targeting the shorter end of the bond yield curve (which resulted in the yield curve becoming inverted - an indication of potential recession) and forcing the banks to borrow at marginal standing facility (MSF) where the applicable interest rate is 10.25%, which is 3% above the existing repo rate.

As of now, the banks can borrow only up to 0.5% of their net demand and time liabilities at the repo rate, and any requirement beyond that can only be borrowed at the applicable MSF rate. This measure did help prop up the rupee temporarily, but then it slid again, close to 62. One cost of the unsuccessful attempt at forcing the rupee down was the RBI's reputation. Now, while the rupee is still weak, the faltering economy is saddled with a much tighter monetary policy, which can drag down growth even further.

Of course, with the government failing miserably in its own policy-making front, Subbarao was waging a lone battle and hence was forced to take actions that he might otherwise have eschewed. Nevertheless, Subbarao's experience has important lessons for Rajan.

For starters, inflation in India is not really a monetary phenomenon and hence the efficacy of monetary policy in tackling inflation is limited. Despite telltale evidence of demand destruction, inflationary expectation in India is high, although core inflation is benign. While central bankers the world over generally focus on core inflation, in India, non-core inflation - involving food and fuel - has a large impact on overall inflation, and that is the structural part of inflation for which the blame lies mostly with the government and its economic mismanagement.

That makes managing inflation in India a particularly tough act, especially when the government refuses to walk the talk. There is constant pressure on the central bank to focus on growth even during periods of high inflation, as only high growth will ensure the higher revenue that is important to fund ever-growing social sector spending.

Rajan's biggest challenge will be to ensure the RBI's independence so that monetary policy becomes credible and effectively able to meet economic challenges head on. However, he does not have any rabbit that he can pull out of the hat to tackle those challenges. He needs the support of the government to achieve his objectives.

This, however, seems quite unlikely, especially in an election year. Even if it were otherwise, the government's penchant for interference means Rajan will have his task really cut out. For India's sake, one must hope he finds a way to avoid frustration in pursuing his goals.

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