Diagnosing the depreciating ₹

The Reserve Bank of India's liquidity-tightening measures are no match against sheer economic mismanagement

WORLD MONEY

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The sharp depreciation of the rupee and the liquidity tightening blitzkrieg unleashed by the Reserve Bank of India (RBI) in response has been the top-of-the-list business news for quite some time now, given their potential ramification on the struggling economy.

To understand the efficacy of the policy measure, it is important to diagnose the disease properly, the symptom of which is depreciation of the currency. There are four related channels that engender currency depreciation — current account deficit (CAD), savings-investment gap, high inflation and falling productivity.

The biggest concern is, of course, the CAD, which, for the past two years has been above 4 per cent of the gross domestic product (GDP). And, contrary to popular belief it is not gold that caused high CAD. While the level of gold import is high, it actually fell last year. And a weak external sector is only a partial explanation of the malaise. The fact is, the impact of faulty policies of the past and sheer economic mismanagement has finally caught up. Dieselisation of the economy as a consequence of an ill-conceived oil subsidy and inefficiency of the power sector (causing increased demand for diesel generated captive power as supply falls woefully short of demand) resulted in oil imports going up even when the economy was slowing. Also, despite having about 10 per cent of the world's coal reserves, India's coal production has been woefully inadequate in meeting the requirement of thermal power plants (India's main source of electricity) requiring its large-scale import. Add to that, the virtual comatose state of India's mining sector induced by policy inadequacies which have resulted in a sharp fall in India's iron ore export. High CAD is, therefore, quite natural.

Another way of looking at the CAD problem is the rising gap between savings and investment. As of FY12, while India's investment rate fell by 3 per cent from its peak of 38 per cent of the GDP, the savings rate was down by a whopping 6 per cent to 30.8 per cent. This gap widened last year. While government's profligacy resulted in high levels of fiscal deficit and hence dismal levels of public savings, household savings were hit by high inflation and resultant negative real rates of interest. High inflation resulted in households saving an increasingly lower proportion of their disposable income while negative real rates caused a flight of savings away from financial savings and on to physical savings, primarily gold.

Inflation is another major concern. Although the official gauge of inflation, i.e. the wholesale price index (WPI), is falling and is now below 5 per cent, it is not an appropriate measure of inflation, especially given that the retail inflation (consumer price index) is hovering close to 10 per cent. Even the GDP deflator method of calculation of inflation indicates a higher level of inflation compared to WPI. As we are all aware, the primary reason for high inflation is severe supply-side bottlenecks — caused mainly due to economic mismanagement. Since WPI is the basis for calculating the real effective exchange rate, the perceived fair value of the rupee is approximately 58/USD, which is what the RBI is targeting. However, if we consider the deflator method of calculating inflation, the fair value of the rupee is around 62/USD.

Another reason for the weakness of the rupee is falling levels of productivity in the economy. The ICOR (incremental capital-output ratio) has fallen drastically over the past couple of years, indicating a major loss of competitiveness. At over seven, it is at an abysmal level. An important reason the ICOR has nosedived is that a humungous amount of investment (approximately ₹7 trillion worth of bank funded projects) is stuck at various levels of implementation (due to ineffective policy making), thereby making capital that much less productive.

Clearly, whatever channel of influence we look at, the overriding cause of rupee depreciation is sheer economic mismanagement. Unfortunately, the RBI is fighting a lone battle. As a result, it has moved away from managing the volatility of the rupee to targeting a specific level. While doing so, it is constrained by the impossible trinity (trilemma or impossible trinity says we cannot meet all the three objectives of free capital flow, fixed exchange rate and independent monetary policy). One is, therefore, not surprised by the zeal with which the RBI is targeting liquidity.

RBI's recent action reminds one of similar action taken between late 1997 and early 1998 — when the rupee plunged by about 10 per cent following the Asian crisis. Then, the RBI responded by raising rates and increasing the cash reserve ratio. However, while during both these periods, growth remained weak, India's CAD then was only 1.5 per cent of the GDP, unlike now. Also, while external debt-to-GDP has been more or less the same, what has changed is increased reliance on short-term debt. From around 5 per cent (of total external debt) then, it is now close to 25 per cent. More worryingly, short-term debt as per residual maturity is as high as 44.2 per cent of total debt and more than 60 per cent of reserves.

Clearly, there's enough and more reason the rupee should trade around 62. While that will mean short-term pain in the form of high inflation, that's the only way India can regain some competitiveness till we see real action on the policy front.

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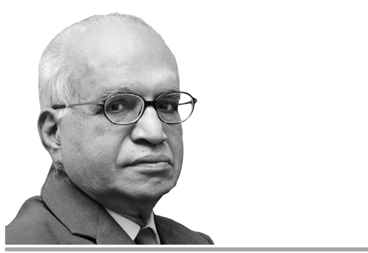
Should India float international bonds?

Promoting NRI deposit accounts in banks seems a better option because transaction costs are lower and inflows more manageable



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REUTERS

What should worry the Reserve Bank of India (RBI) at a time of depreciation of the rupee and declining forex reserves is the enormous liability of $172 billion falling due for repayment by March 2014. It will account for around two-thirds of total foreign currency assets of $252.1 billion, as on July 26, 2013, with no immediate prospects of any accretion. It will be the last bulwark against the country defaulting in discharging obligations, if external receipts do not come to its rescue. We experienced the problem in the Gulf Crisis.

As for market intervention to stem depreciation, if the Reserve Bank of India (RBI) has to make a sizeable impact on the market, it has to deploy large amounts. Its reserves are hardly equal to five to six days of market turnover. It has to be in the market continuously to achieve its objective. Then, it will run out of reserves within a few weeks as was the case with Thailand, that led to the East Asian crisis and the exchange rate will be back to square one.

The immediate need is to strengthen the reserves and arrest the depreciation of the rupee through the inflow of capital. There have been talks about floating a sovereign bond in international markets. If the purpose is to augment the reserves, whatever resources the country raises will be added to RBI's kitty. It will be invested in low-yielding treasuries of foreign governments and deposits of international institutions. The net outgo due to the difference between interest paid and investment income will be a drain on the forex resources. There are legal problems in floating bonds in the US limited to non-resident Indians (NRIs). And that is the country where there are a large number of high net-worth NRI professionals looking for good yields. At his post-policy meeting with the press, the RBI governor mentioned his reservations about floating a sovereign bond. The central bank has done a cost-benefit analysis of the matter. There are standard textbook arguments like it will lower the interest rates, establish a benchmark for government borrowing and broaden the investor base. But there are costs also besides the compromise in our financial stability. The time for a sovereign bond issue is when we are much less vulnerable to economic shocks than now. In my view, these considerations also apply to banks and corporations floating bonds where the interest rate will be higher than in the case of government borrowing. Rough calculations show that the total cost is likely to be around 10 per cent after factoring in hedging costs.

Would it not be better to promote the NRI deposit accounts in banks? The banks may be expected to utilise the funds for the benefit of the country. They can issue forex loans to corporations on terms competitive in international markets. After the removal of restrictions on interest rates, the non-resident external rupee deposits have seen a spurt in flows amounting to $15.8 billion during 2012-13, against $8.5 billion in the previous year. Data show that much of the flows into the external rupee account were likely to have been diverted from the other two NRI accounts to take advantage of the higher interest rate. Unlike the rupee depositors, who are mostly semi-skilled migrant blue collar workers sending funds to India for domestic maintenance, foreign currency account holders are high net-worth individuals settled abroad. They comprise professionals in various fields who are looking for good yields against the near zero rates prevailing in the West (around 0.15 per cent for one year). Although the interest is free of income tax in India it is not so in the US. Thus, the after-tax difference in interest income may not be much under the current rates in India. The RBI should revisit the issue and consider removing the remaining restrictions on interest rates on foreign currency deposits. It will give a significant boost to inflows. Banks may be expected to be responsible to fix the rates at a viable level. The cost, including the transaction cost, would be less than that of the bond issue.

The fear of arbitrage operations and the subsequent run on forex deposits witnessed during the Gulf Crisis should not be a deterrent. India and the world have changed so much in the meantime

The fear of arbitrage operations and the subsequent run on forex deposits witnessed during the Gulf Crisis should not be a deterrent. India and the world have changed so much in the meantime. As an added incentive, the RBI can exempt fresh accruals to all non-resident deposits from the statutory liquidity ratio considering the current excess investments in government securities.

One important factor that needs to be kept in mind is the impact on money supply. If the forex were to be surrendered to the RBI there will be a one-time massive injection of money when it comes through the bond route. Then, the question of sterilising the inflows will arise with its attendant costs. In the case of NRI deposits, there will be periodical flows that can be managed even if the central bank buys the forex. The question of a massive bullet repayment of loans raised through bonds with its attendant problem after, say, five years, would not arise in the case of deposits where it will be staggered. Although the remittances of NRIs may continue, there could be a deceleration in its flow in view of the restrictions being imposed on expatriates in some of the Gulf countries. The need for capital inflows to make up the current account deficit may be even more in this year than in the last. While foreign institutional investor flows into equity and debt are reversible, foreign direct investment will take time to fructify.

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CHINESE WHISPERS

Raman Singh & the rice god

BS PHOTO

Chattisgarh Chief Minister Raman Singh (*pictured*) does not suffer undue modesty when it comes to accepting the plaudits that are heaped on him for being the first state to enact the food security and nutrition Act. Singh, recently in Delhi to participate in a seminar that was organised specifically to celebrate him and the new law, related a story to demonstrate how people in his state viewed the food security law. Travelling in the interiors, he asked a man he met in a forest village who had provided him 35 kg of rice at ₹2. Singh said the man replied: The rice is given by *chawal wale baba* (the rice god). Thus, said Singh triumphantly, the forest dweller did not know either the chief minister or anyone else in the administration but had paid the richest tribute to him and the scheme. What more praise can one get? he asked rhetorically. Too true, but Singh may want to hold the self-congratulation a bit, since many forest dwellers in Chattisgarh were forced to live in hiding or in camps for nearly a decade as a result of the armed conflict unleashed by Singh in the form of the government-sponsored Salwa Judum against the Naxalites.

'Solution' for inflation

The talk on the street is that the government seems to have accidentally found a solution to raging food price inflation. The National Spot Exchange Ltd has said it would liquidate commodity stocks worth over ₹6,000 crore if the payment crisis persists. Brokers say if these stocks flood the market, prices will come down drastically. "How much can people hoard against such supply? Also, the rains are good this time. So, fresh supply will also come in. All in all, we can finally kill the ghost of inflation, which is good for the stock market," a broker joked.

Hands-free option

Hearings at the special Central Bureau of Investigation court on the 2G telecom spectrum case are not without their moments of unintended humour, notwithstanding the gravity and complexity of the issues under discussion. One such moment was provided by Som Subramaniam, former chief financial officer (CFO) of BPL Communications. He had already been reprimanded by judge O P Saini for giving long-winded and evasive replies but seems to have heeded this warning lightly. Thus, when asked about his involvement in the share-purchase agreement between Essar Teleholdings and BPL Communications, he went off on quite another tangent. Even though he was the CFO, he said, he did not handle the paperwork for that particular deal. He added, "It is correct that this was despite the fact that I was group CFO. I was happy with this arrangement as I had no option. If I was not happy, I would have quit the company, but I did not get any offer."

LETTERS

BS PHOTO

Industrial revival

This refers to the report "Mamata rolls out red carpet to India Inc" (August 2). One should appreciate Banerjee's energy and enthusiasm in building partnerships and to do away with the notion that West Bengal is a laggard in investment.

The present investment scenario in the state is quite gloomy. The chief minister need not be upbeat about the feelers from corporate heads of Mumbai to set up industries in the state, rather she needs to address the root causes that have been plaguing the industrial climate by freeing industry from the extortion of local party bosses and by bringing about a better work culture. She has to categorically specify the land ceiling policy, special economic zones, good governance, foreign direct investment and delivery system of the government.

One more glaring effort at industrial rejuvenation in the state is that the Calcutta Stock Exchange — which is one of the oldest capital market institutions and has been an integral part of Kolkata's history— is currently waiting for its death knell. The Trinamool Congress while releasing its manifesto promised to revive the century old exchange, but there is no sign of intervention in salvaging this institution.

After being in power for two years, the realisation seems to have dawned on Banerjee that industrial development is essential for progress. While replying to business barons on the question of militant trade unionism her remark that "things are not that bad" was a gross understatement.

The then Chief Minister Jyoti Basu went to the US to woo business and so many memorandums of understanding were signed but not implemented.

Sankar Lal Singh Kolkata

The price rise pain

This refers to the report, "Petrol price hiked by 70p a litre, diesel by 50p" (August 1). In the past two months fuel prices have been revised five times and the worst sufferer is the common man. It goes without saying that the cost of every commodity has increased as a result of this price rise. One has to think that there is something wrong with our economic policy. It is unfortunate that even after 66 years of Independence, we are not able to see the economy grow and the rupee value is oscillating at 60.68/dollar. Despite the fact that the finance minister is an experienced person in the ministry and the prime minister is one of the greatest economists in India, as an ordinary citizen I could not comprehend how this happens. Is it because of the Congress, which has ruled the nation more number of times than any other party with critical and grave financial policies? Or is it because of the corruption that prevails all over the nation? The opposition parties make a hue and cry whenever there is a price rise and keep mum afterwards.

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