THE OBSERVER
OF BUSINESS AND POLITICS
TUESDAY JANUARY 31, 1995

Problems of plenty

Demolish the mindset that export competitiveness depends only on the exchange rate, says **Uttam Gupta**

VERY often, India is caught in one or the other extreme crisis. Take the foreign exchange position. Only three years back, our foreign exchange reserves were low to the point of India defaulting on international payment obligations. Inflation rate then was at a high of 17 per cent. Now, the pendulum has swung to the other extreme — with foreign exchange reserves of over $20 billion. Contrary to the RBI's contention that this much foreign exchange is manageable, the facts clearly reveal their high inflationary effect.

During April to October 1994, the increase in net foreign exchange assets of the banking sector was Rs 18,202 crore — almost three times the increase (of Rs 5,502 crore) during the corresponding period in 1993. Interestingly, the increase in the narrow money (MI) stock, which includes currency with the public and the demand deposits with the bank (against broad money M3 which includes time deposit, as well) during April-October, 1994, was also of the same magnitude — Rs 18,098 crore — representing an increase of two-and-a-half times over the corresponding period of 1993.

The demand deposits with the banking sector alone increased by Rs 8,904 crore as against an increase of only Rs 416 crore during April-October, 1993. There has also been a significant increase in the currency with the public which went up from Rs 7,104 crore in April-October, 1993 to Rs 9,194 crore during April-October, 1994.

The emerging trends in the growth of narrow money stock and its perfect symphony with the increase in the net foreign exchange assets in the banking sector, clearly demonstrates the failure of the RBI's sterilisation operations to mop up excess liquidity from the system.

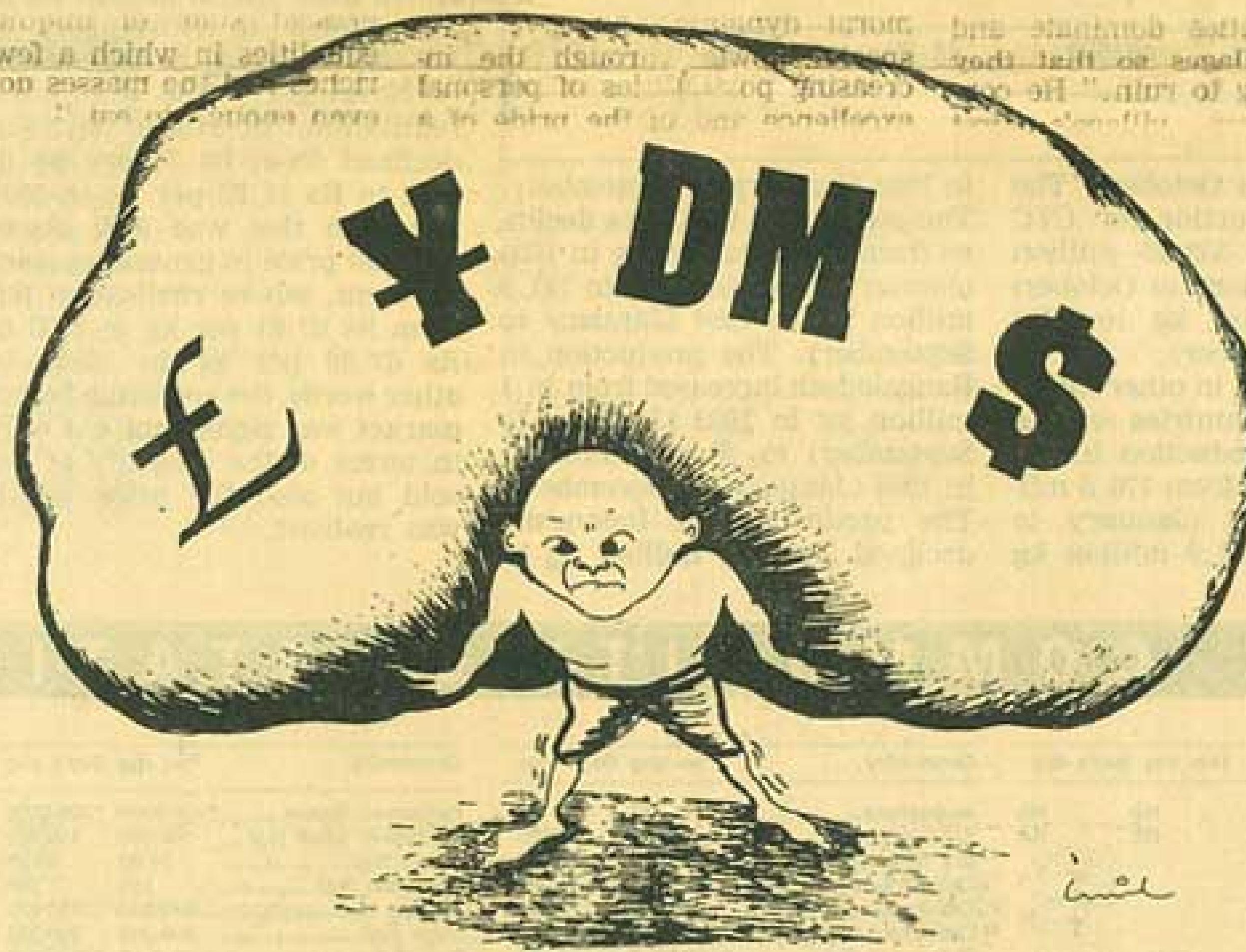
In a bid to prevent appreciation of the rupee and resultant adverse effect on exports, the RBI mopped up all incoming excess dollars from the market. However, it did practically nothing to mop up the consequential increased rupee resources from the system.

The resultant acceleration in the broad money supply was bad enough. However, still greater acceleration in the narrow money stock has made things even worse. This trend has been aggravated by falling interest rates on time deposits which has forced people to keep their money either as demand deposit in the bank or in the form of currency. The fact that inflation still continues unabated has bolstered inflationary expectations and prompted people to make their savings as much liquid as possible to facilitate immediate response to a situation of shortage.

That this would propel inflationary forces during the rest of the year and even in to the next year is a foregone conclusion. Further addition to the money supply is inescapable primarily on account of the inability of the government to contain the fiscal deficit at the projected level of 6 per cent. Reportedly, an additional Rs 1,100 crore is likely to be sanctioned by way of supplementary demand to cover increased subsidy on fertiliser. There is an additional demand of Rs 700 crore to cover additional subsidy on sugar imported by STC and MMTC. The substantially increased level of foodgrains stocks with the FCI will pose additional liability.

Contribution to inflation is coming in a significant way from another source: administered prices of basic inputs and infrastructural services. Even the prices of food have increased by a whopping 60 per cent since 1991. Whether food or any other basic input used by the industries, both have a cascading effect on inflation.

Considering the vast size of the India's economy, inflow of foreign exchange ordinarily should not have posed much of a problem. Buoyant industrial activity resulting in corresponding import flows, large scale domestic investment in new projects and expansions entailing import of plant and machinery and spares and a fairly liberalised import regime for raw materials, intermediates and even consumer goods would have ensured utilisation of incoming foreign exchange without any problems of liquidity overhang. Under such circumstances, the latter could in fact, be converted into a potent instrument of stepping up overall rate of industrial and economic growth. This excellent opportunity has been allowed to wither.



Except for a couple of sectors, the recovery of industrial growth in the current year in still to gather momentum. Majority of investment plans are being kept on hold for one reason or the other. Bureaucratic delays still play a major role. For the seven power projects which were to be on the so-called fast track, the zero date is yet to be decided.

Foreign companies are being asked to raise rupee resources from domestic financial institutions while there is no reason why the dollars cannot be used for the purpose.

Liberalisation of consumer goods imports is being talked for quite some time now, but no decision is forthcoming. This step alone, with reasonable customs duty, can help in relieving the situation.

If we can set things right on these fronts, which will spur economic growth and substantially enhance availability of goods and services at low cost, there is no reason why we should not allow even the rupee to appreciate, to some extent, depending on the demand-supply balance for foreign exchange. The fear that appreciation of the rupee vis-a-vis the dollar will affect exports is totally unfounded.

This is for the simple reason that in a reverse situation where the dollar is maintained at, say Rs 32, the disastrous effect on inflation and consequential increase in the rupee cost itself will more than offset the benefit due to pegging of the exchange rate at that level. It is absolutely necessary to get rid of the mindset that export competitiveness depends only on the exchange rate.

The fact that export growth during the first half of the current year was down despite the rupee being artificially undervalued is ample proof that there is no escape from controlling domestic inflation.

That would require effective fiscal management and efficient overall governance notwithstanding the emerging political compulsions to be profligate again.

Beating inflation and inflationary expectations has been rendered difficult not because it is an insurmountable task, but primarily due to the government's inability to take hard decisions.

When a country like Argentina can reduce its inflation rate from as high as 400 per cent in the 80s to just below 4 per cent now and turn a situation of huge budget deficit into surplus, there is no reason why we should not aim at that and come out successfully.

India is unambiguously much better equipped to carry out the task. What is needed is the necessary political will and proper gearing of the administrative machinery for effectively translating the declared intentions of monetary and fiscal policies.