All this handwringing

The economy calls for collaborative action, not despair

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WHEN the going gets tough, prophets of gloom and doom are available in plenty. It might be prudent to ignore them for a change. Instead of deriving a sense of vicarious pleasure from endlessly analysing how bad things are in the economy and markets, and then finding a convenient door to lay the blame on, the various stakeholders in the economy should put their heads together and take some action.

To begin with, it is important to understand a few facts. The fundamentals of the economy are not half as bad as the vicious fall in the financial markets would suggest. Take GDP growth for instance. We have had a fantastic monsoon, so god is with us. This is all set to yield a good harvest, and a spurt in consumption spending typically comes in its wake. Merchandise exports seem to be picking up as the US economy, and finally Europe, show signs of slow recovery. Services like IT are also likely to do better, given the recovery in the West and a cheaper currency. Projects in key infrastructure areas like power are gaining traction, thanks to the government's efforts to expedite matters. Put all this together and a growth rate in the ballpark of 5.5 per cent seems eminently possible for 2013-14. This is, incidentally, a growth rate that both developing and emerging markets would give an arm and a leg for.

The irony of today's situation is that the current account deficit (CAD)— the one thing that everyone likes to blame for India's woes — is set to improve considerably this year. The consensus among economists is that the CAD this fiscal is unlikely to breach 4 per cent (about $75 billion), compared to 4.8 per cent of the GDP ($88 billion) last fiscal. The improvement is likely to be on the back of improving exports, reducing gold and oil imports. Besides there were hefty food imports last year to meet the supply shortages created by a delayed monsoon.

This is not to deny a couple of facts. First, given the turbulence across global markets as the US Fed prepares to taper its massive $85 billion a month bond-buying programme, even a much smaller deficit is, at least temporarily, proving difficult to finance. Second, much more can be done to reduce the CAD and bring it down to more manageable levels, say 2.5 per cent of the GDP.

Let us take up the issue of financing the CAD first. The government has proposed raising funds through quasi-sovereign and other PSU bond issues, which could make a difference, as would the further liberalisation of non-resident deposit rates. The amount that the government projects is likely to come through these channels (roughly $12 billion) is not aggressive, hence credible.

But the assumption that these measures will stabilise the rupee within a few hours of their announcement (or that their inability to work this magic is de facto a sign of their ineffectiveness) is both bizarre and naive. It takes time, for instance, to raise funds through bond issues and for these inflows to translate into a fresh supply of dollars that will have an impact on the exchange rate.

It is imperative that policy announcements clearly define the purpose and a likely timeframe for these measures. We don't need a magic wand to increase supply and reduce demand for dollars. That's what will happen as the measures take effect.

Let's take the case of hiking import tariffs on non-essential items and begin with some facts. The CAD is not about oil and gold alone. In 2012-13, while the aggregate CAD was 4.8 per cent, the CAD excluding gold and oil was 3.8 per cent. In an import bill of about $500 billion, about $280 billion was non-gold and non-oil. We imported about $30 billion of electronic items alone in 2012-13. Any strategy to compress the deficit will have to involve reducing this component of imports.

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There are both short- and long-term solutions. In the short term, hiking import tariffs on non-essential items is the logical answer. While it might appear to be a regressive step to proponents of free trade under any circumstance, there is no need for the government to be defensive. Our peak tariff rate of 10 per cent is way below our WTO binding commitments. We also have to deal with dumping and arbitrage (TVs from Thailand, Ganesha's from China). Raising import duties, at least temporarily, is a textbook solution for countering a strain on our balance of payments. It is both misleading and irresponsible to describe this as a reversal of reforms. The same logic applies to duties on diesel. Our oil import bill is approximately $170 billion. We have to ensure more efficient use of fuel and promote conservation.

In the longer term, we need to address some critical supply bottlenecks to get our deficit down. Coal imports are the single biggest item on our balance of payments after oil and gold. The rise in coal imports is the direct result of the inability to mine domestic reserves because of environmental regulation, judicial action and the prohibition on allocating blocks to private miners. From $9 billion in 2009-10, coal imports jumped to $16 billion in 2012-13. On the export front, similar issues have crippled iron ore, one of our principal export items.

How can this be addressed? At the moment, there appears to be an impasse but the solution is simple. All the entities — the judiciary, the government, the environment lobby, the private contractors have to find a middle ground in the best interest of the economy.

The prophets of gloom have raised fears about a large slippage in the fiscal deficit in the run-up to the elections. Instead of accepting this as inevitable, it might be prudent to wait and watch. The finance minister has clearly drawn a red line below the deficit target of 4.8 per cent. His recent track record speaks for itself. In 2012-13, when most pundits had predicted fiscal disaster with forecasts of over 6 per cent of the GDP as deficit, the actual deficit was just 4.8 per cent of GDP.

The world has changed and the objectives of monetary policy need review. It seems that coordinated action on the monetary, fiscal and growth front would be necessary to achieve the objectives.

The draconian monetary measures aimed at wringing speculation out of the currency markets seem to be doing more harm than good. The escalation in money market rates and bond yields is bound to transmit to bank deposit and lending rates. This is likely to hurt growth and, as the rating agency Crisil recently pointed out in a report, increase the risk of default by Indian companies. As overseas investors and lenders factor this in, it could hurt foreign currency inflows. The attempt to defend the slide of the rupee could be self-defeating. Instead, steps to boost growth by creating an environment conducive to investment, fast-tracking infrastructure projects and reducing imports will prove to be far more supportive for the currency in the medium term.

The RBI's recent steps to infuse liquidity by buying long-term bonds and offering banks some relief on bond portfolios battered by a sharp (and irrational) rise in bond yields are sensible measures. The next step could perhaps be a reduction in the percentage of daily CRR balances that banks have to maintain from the current level of 99 per cent. These small gestures could go a long way in soothing the frayed nerves of investors and corporates.

In conclusion, India's future is bright. There is a need for collaborative action but no need for despair.

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