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The Way Out of the Current Macroeconomic Mess: A Note

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Abstract

The current situation of a large CAD, low growth, and plunging rupee is a result the combination of early withdrawal from the fiscal stimulus and the RBI's monetary conservatism. There is possibly a way out if credit can be expanded to close the differential between the low end government bond yields and the repo, accompanied by a large push on investments with an appropriately structured investment tax credit valid for the next twenty four months. It could crowd in investments to attract FDI and portfolio investments and if the RBI does not allow the current rupee to appreciate in real terms then the CAD could close, with reasonable growth as well. Without these actions the holding out operations on the currency by the RBI can at best delay the further fall in the rupee, and growth which would have a await a protracted recovery from the expected rise in exports some six months from now.

The Way Out of the Current Macroeconomic Mess: A Note

The economy has been in a recession for over a year now. This had been anticipated way back in 2011 by many including me, when not only did the government prematurely exit from the fiscal stimulus but the RBI began raising repo rates. Thus, “I (Morris) would call it (rate hike) madness. It will kill industry and investments,” ... “and repo rate increase in present circumstance is against elementary understanding of macroeconomics. “Indian inflation is a product of higher crude and agri-product prices and fund flows from NREGA; it's not because of low interest rates. And hence, increasing repo rate is creating possibilities of fueling inflation in the long run” (Repo rate hike: Corporates say move will hurt industry, some call it madness, ET Bureau Jul 27, 2011, Seshagiri Rao). The RBI's subsequent draconian measures more than even the governance mishaps of the central government (which came only over the last seven months) of credit rationing while raising rates, brought investment levels to practically nothing at all. These actions were sought to be “justified” on account of the high fiscal deficit and the “high” inflation. It is silly to fight a supply side inflation on basic food in a poor economy by killing off demand for autos, durables, real estate, and manufacturing which is what would happen when interest rates are raised and credit is put on a tight leash. For that “to work” the RBI would have had to kill growth so severely that the poor now out of jobs would have to reduce their food demand! The middle class and above could not have adjusted since their income would have to fall to less than a fifth before they buy any less food! The subsequent argument made by the RBI that inflationary expectations had been built which needed to be counteracted was also not factually correct –since the inflation in manufacturing was entirely due to the pass-thru effect of high food prices on wages and on agricultural input goods into manufacturing –there being no secular increase in the inflation. The continued pursuit of a demand side fix also exacerbated the problem for the government since the indirect taxes which have an elasticity greater than unity with respect to GDP (an interesting peculiarity in India over much of the post reform period). Additionally, the high interest rates ensured that despite the exit from the stimulus the fiscal deficit remained high. The biggest mistake made by the RBI was during 2007 -2008 over the year before the global crisis, when instead of keeping the nominal value of the rupee down it allowed nominal appreciation having lost the ability to carry out sterilisation in the wake of large capital inflows during this period. Over the same period China increased its reserves by close to 2 trillion dollars. India could easily have increased its

reserves by another 250 billion dollars so that now it would have been sitting on upwards of 500b\$ that would have allowed it (like China, SK, Taiwan) to weather the turmoil in the global capital market due to US central bank actions.

The point is it is wrong (whatever the IMF and the RBI may think) to consider capital a/c balances and current a/c balances equivalently for emerging economies because large current account deficits (CAD) cannot be financed for long even with non-debt creating inflows (FDI and FII) without the ability to service the same. Thus a CAD higher than 2% of GDP (at a growth differential of 4%) would be non-sustainable. India reached non-sustainability when its growth fell to 7% (when the rest of world average growth was 4%) and CAD to 3.5%. In other words the rupee was overvalued and had to come down. Now there is huge difference between maintaining a low but sustainable exchange rate (from where it can only appreciate or lead to reserve accumulation) on the one hand, and allowing markets to push overvalued or “equilibrium priced” currencies down. The intrinsic bias of markets (investors tautologically call it country risk) against emerging market currencies needs recognition on the part of their central bank governors. It is this feature that gives functionality to reserve pile up, as the Chinese and some East Asian countries have built on to their great advantage.

Since Raguram Rajan’s take over as RBI governor one improvement that has come to the macroeconomic situation is his unwillingness to control both the policy rate and the money supply through credit rationing (closing the repo window prematurely). Over the last two years or more the low end government bond yields have not been collared by the repo-reverse repo, which negates the loud claims of the RBI that it has always stepped in to provide liquidity. Now under RR with a commitment to liquidity through the repo window or by raising the repo to eliminate the rationing situation, the repo would collar the low end bond yield rates, allowing the repo to be truly policy rates.

Given the recession it is important that rather than raising rates the liquidity needs to be expanded to even lower the repo rates. This position needs to be kept up even if money supply rises beyond targets. On the back of such a commitment to liquidity, the finance ministry has a very powerful instrument in instituting an investment tax credit (ITC) to bring the economy back in line. The ideal form the ITC should take would be a 50 % tax credit on all investments (most certainly in manufacturing) made from now on over the next 48 months which can be set off against future taxes to be paid. Thus if an industry makes a spending on

investment then it would earn (tax) offsets to the extent of the spending on future taxes. This would break the pessimism, and as a few companies make the investment others would follow for reasons of competition and rising demand. It would be non-inflationary as well since the expenditure that would be crowded in would also increase the capacity output. FDI and portfolio investments would both resume, and if then the RBI then buys up the dollars to not allow the real effective exchange rate to appreciate (as calculated by inflation on manufactured goods in India), then the CAD should close without a steep fall in growth – unlike the current policy which would require a decimation of growth before the CAD comes in line. The direct cost would be very small since the offsets come in the future on a much larger economy. The indirect taxes and direct tax base increase would more than compensate for the same. Why would this work for India?

Emerging markets with a diversified industrial base (the big Latin American countries, China, India, much of East Asia, ASEAN and many others) can only be capacity constrained but not labour constrained since they either have vast disguised unemployment and /or have labour ready to be engaged at higher productivity on newer capital equipment. But only the export-led growth economies (China, Taiwan, Korea, Thailand, Vietnam (now), Malaysia) have systematically taken advantage of this opportunity through expansionary monetary and fiscal policy that increases investment expenditure during crisis (and otherwise) at high enough rates to increase the capacity output while increasing demand as well. Idle /underemployed resources mean that there is this escape route of investment led growth as long as the capacity output is not allowed to fall below the actual output. And undervalued exchange rates mean that the same can be made foreign exchange consistent as well.

To summarise there is possibly a way out of the current situation if credit can be expanded to close the differential between the low end government bond yields and the repo, accompanied by a large push on investments with an appropriately structured investment tax credit valid for the next twenty four months. It could crowd in investments to attract FDI and portfolio investments and if the RBI does not allow the current rupee to appreciate in real terms then the CAD could close, with reasonable growth as well. Without these actions the holding out operations on the currency by the RBI can at best delay the further fall in the rupee, and growth which would have to await a protracted recovery from the expected rise in exports some six months from now.