Is the Party Over?

Rohit[1]

To answer this question, one needs to look at the performance of the Indian economy in the recent past and assess where it is headed. While the growth figures have dwindled in the last few quarters with no clear sign of reversal, there has been back-breaking inflation along with a falling rupee. What is behind these developments and where is it taking us?

The Indian Growth Story

The much talked about Indian growth story, which was apparently decoupled from the global crisis, has come under a cloud with the recent figures of declining rate of growth. Instead of an emerging market, it seems to be submerging in the crisis that has afflicted the world economy. India might not be coupled in the same way as China, which is through its export market but it is a linkage through *finance.* Precisely for that reason it is a far more volatile coupling.

Let me elaborate. First, with increasing income inequalities, the Indian growth story, riding high on financial deregulations of an unprecedented nature, has primarily become one which is driven by the credit-financed consumption as well investment demand of the upper strata of the society and, therefore by its very nature, is not a success story driven by the consumption demand of the poor. This becomes all the more visible by arguments made in favour of 'inclusive' growth, trickle-down by the government and the apologists of this growth story. The significance of this can be gauged from the fact that the *share* of personal loans in overall loans given out to the households by Indian commercial banks has more than doubled between 1996 and 2008. Second, this credit-financed demand requires collateral to sustain the boom in the short-run, which has been provided by the surging asset prices. Third, hot money (primarily the foreign institutional investors) flowing into India is intricately linked to the surging asset price markets in India. It is also visible in highly leveraged financial sector, which has increasingly got dependent on the external commercial borrowings. Fourth, a great part of the export story, which was another driving factor behind the booming services sector, like the IT sector and financial services, are dependent on the extent of outsourcing from the west. Fifth, given the bias towards consumption of the rich or for exports for foreign markets, it has an abysmal potential to create significant employment because of high capital intensity of such products. Little wonder that it has been termed a jobless growth trajectory in common parlance. It's not difficult to see why such a growth story has seeds of its own destruction built into it.

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[1] Rohit teaches at the Centre for Economic Studies and Planning, JNU, Delhi

Dwindling Rupee

Given the growth in favour of goods the upper strata uses, it has a higher import propensity compared to a growth strategy based on mass consumption goods by the poor. In such a situation imports are directly related to high growth of the economy. Demand for some of the commodities, like oil, is downwardly inflexible unless the growth rate nosedives. And if a greater part of this demand is met through imports, this leads to a burgeoning import bill as has been the case with India. On the other hand, since the export markets that India caters to are still reeling under the worst recession since the Great Depression, exports, services in particular, have taken a direct hit. This means increasing trade deficit for the economy, which is nothing else but an increase in the demand for foreign currency (for simplicity US dollar) to finance this extra demand for foreign goods. Now, if a corresponding supply of dollar is not forthcoming either from abroad or through central bank's release of foreign exchange reserves, the price of dollar would rise (or rupee will depreciate). This is what the Indian economy is facing today with rupee valued at its worst ever. This dwindling rupee has quite a few implications.

Looming Crisis in the Indian Economy

First, falling value of rupee also creates an expectation of a further fall, which scares international finance away because they expect losses to be made later when they convert the invested amount denominated in rupee to dollar. Such a capital flight has the potential of destabilizing the currency as happened in the case of the East Asian crisis. On top of that, such is the precarious condition of the central bank that despite having enough foreign reserves, it cannot give the signal of being the lender of last resort since that would further fuel the panic.

Second, this hot money outflow also affects the asset price markets adversely, which, being the backbone of credit-financed demand, limits the growth dimension of the economy. It doesn't take a genius to see that an economy's growth so closely linked to international finance will eventually take a hit.

Third, it creates inflationary pressures in the economy since the international goods become more expensive in rupee terms. This pass-through is clearly visible in imported commodities which are necessities, like crude oil or other petroleum products. Moreover, since fuel prices go into the pricing decisions of many other commodities because of the increase in transportations costs, it leads to a high inflation across commodities.

Fourth, contrary to the common perception that a devalued rupee means better export possibilities, exports might not rise for two reasons: a devalued rupee with inflation might not decrease the prices in dollar terms for the foreign markets; and, more importantly, exports are not just dependent on the value of the rupee but also on the income of the target nations, which are hit by a crisis that hardly seems to be abating. So, it does not bode well for the burgeoning trade deficit, the root cause of the falling rupee.

RBI's Response

RBI's response to this impending crisis articulated by its new governor, Mr. Raghuram Rajan, is not just limited but in my opinion counterproductive. First, he made an array of announcements to placate international finance, the most important of which was further liberalization of the capital account (read increasing the ease with which finance can come in and go out of the economy). It is indeed paradoxical that the same RBI, which is blaming the international capital today for the falling rupee, is also arguing, under the leadership of its new governor, for a facilitation of a capital flight, through easing of capital controls, in the future if the need arises! Second, the recent announcement to increase the interest rate to control inflation is like giving an insulin injection to a heart patient. Inflation created by cost-push factors (like oil and raw material prices) cannot be controlled by suppressing demand in the economy, which is what the hike in interest rates does. If anything this is a recipe for disaster as it will lead to what is called a stagflation i.e. stagnation with inflation since it adversely affects growth without controlling inflation.

Ways Out

Could something else have been done? First, the current account problem could have been curtailed by reining in on speculative gold holding by the propertied classes in India but the response came too little too late. Dwindling Rupee and speculative holding of gold are intricately linked to each other but the causality in the current case is primarily running from the latter to the former (because the latter is fuelling the current account deficit) so unless the latter is controlled, the former can't be arrested and that needs high duties on gold imports in the short run. Second, the burgeoning oil bill can also be controlled through: (a) redirecting the oil exports of domestic oil companies to the domestic market; (b) diversification in favour of other oil-substitutes like natural gas etc and development of technologies which are less oil dependent. Third, instead of a clamour for more reforms in the financial sector and the capital account, which would make both the inflow and outflow of hot money easier and aggravate the problem, there should be a move towards more capital controls. Fourth, in the medium-to-long run, the import intensity should be curtailed through structural changes in the growth process of the Indian economy, by moving away from the current job displacing elite-based demand trajectory towards more job creating mass-goods demand trajectory. But all of these, or other such steps, require not just sound economics but breaking the umbilical cord with international finance, a step which entails a political reorientation of the government.