④ ISAS Brief
No. 159 – 16 April 2010

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Monetary Policy Pressures in India: A Comment

S. Narayan[1]

Abstract

The Yuan-Dollar exchange rate decisions are likely to have an effect on how the Reserve Bank of India (RBI) manages its exchange rate policy. This is likely to add to the monetary policy concerns that the RBI has to address. This paper highlights some of the dilemmas before the RBI.

The consequences of the dispute between the United States (US) and China over the Yuan-Dollar exchange rates are likely to have some consequences for India. Since July 2008, China has kept its exchange rate pegged at 6.8 renminbi (RMB) to the dollar, a rate now widely considered to be unrealistic. Between 2005 and 2008, China allowed its currency to appreciate against the dollar by nearly 20 per cent, but this resulted in hot money flows into China by investors seeking arbitrage opportunities ahead of the appreciating Yuan. Financial and real estate asset prices ballooned, and China went back to affixed exchange rate in July 2008. While the US says the Yuan's valuation has led to the massive trade deficit between the two countries and global trade imbalances, Chinese officials say restrictive US policies on the import of Chinese machinery are to blame for the gap. China has reiterated its position on 12 April 2010.

"Renminbi appreciation would neither balance Sino-US trade nor solve the unemployment problem in the US. Detailed measures for reform should be considered in the context of the world's economic situation, its development and changes as well as China's economic conditions. It won't be advanced by any foreign pressure," said Mr Hu, according to a statement released by the Foreign Ministry.[2]

---

[1] Dr S. Narayan is Head of Research and a Visiting Senior Research Fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He is the former economic adviser to the Prime Minister of India. He can be contacted at snarayan43@gmail.com. The views reflected in this paper are those of the author and not of the institute.

[2] The Hindu, Chennai, 13 April 2010.

Notwithstanding the sentiments expressed, it is likely that China would announce some revaluation of its currency in the next few days, and also allow the currency to trade over a wider band than presently. At the same time, the steps would be measured in a manner that would lend credence to China's arguments that its exchange rate is not the villain of the piece. And herein lie the concerns for India.

First, as the Yuan appreciates, it is likely that countries that are exporting to China would see a strengthening of their currencies as the markets factor in these additional earning expectations. One could reasonably expect the Yen and the Australian dollar to appreciate, as also currencies of countries that are net exporters to China. While the Rupee may not appreciate in view of the large trade deficits that India has with China, it may result in imports becoming more expensive. Imports from China are not merely consumer goods and toys, but also a substantial amount of capital goods like power plant equipment and telecommunication equipment as well as electronics and white goods. The demand for these is fairly inelastic and hence imports may not go down, but prices, as well as current account deficits with China, may go up. If other currencies like the Yen and the Australian dollar appreciate, imports from these countries, including commodities and consumer durables, automobiles etc. are likely to become more expensive, adding to inflationary pressures in India.

Second, analysts have pointed out[3] that as net exports (exports minus imports) from the US and China increase, the burden of absorbing this increment in net exports falls on the rest of the world. Given its current account deficit, a rise in US net exports makes sense. The same cannot be said for China with its massive current account surplus.

Therefore, with India's sizable current account deficit it makes little sense to have an appreciating Rupee. Yet that trend is likely to continue as long as net capital inflows are robust and the RBI refrains from active intervention. The appreciation of the Rupee would certainly hurt Indian exports, and the RBI may have to get back to sterilising inflows and to some capital account management. The alternative course of action is to moderate net capital inflows. There are various instrumentalities, including tightening of Participatory Note (PN) regulations, reduction of external commercial borrowing, etc. None of these options is neat and clean. The only reason that can be attributed to the RBI not doing it till now is possibly the concern that sucking out the excess liquidity may affect the fiscal borrowing programme of the Government, in a year where fiscal deficit, and hence borrowing, has been very high.

This leads to the third issue, and that is the consequence of the liquidity in the economy. On the one hand, there are concerns about inflationary pressures, caused by rising food prices, and more recently, the increasing commodity prices of iron ore, crude oil, copper and other metals that would have a price effect on Indian products. Some of these price effects are structural, and may not be amenable to monetary policy measures. The hot summer being experienced could well be the precursor for a good monsoon, thus alleviating pressures on food prices, and in any case, there are sufficient buffer stocks of cereals to provide for distribution through the coming season. However, the concern over non-food prices would remain.

[3] Business Standard, 10 April 2010.

There appear to be two different factors contributing to these price pressures. The first is the excess liquidity in the economy, exacerbated by capital inflows, that is fuelling increases in asset prices in financial markets as well as in real estate, which is creating concerns of an asset bubble resurfacing. The social sector programmes of the Government, which are pumping in close to US$15 billion[4] into the National Rural Employment Guarantee Act (NREGA) and other subsidy programmes are adding to the consumption pressures. The fact that unknown investors are able to pay over US$300 million[5] in an auction for a cricket team, point to the availability of free resources in the economy that are not being deployed for productive investment, but only to raise valuations.

A second source of inflationary pressures arises from supply constraints. Demand for steel, cement, construction material and equipment as well as for power generation equipment, electrical machinery and heavy earthmoving machinery is at an all time high, and manufacturers have long waiting order books. At the same time, the sub-suppliers to the large factories, the SMEs, are not being able to add to capacities fast enough. During the last one year, there were a number of infrastructure projects that achieved financial closure. There is considerable activity in the power sector, and several other projects including roads, Special Economic Zones (SEZs), airport projects and ports are investing in construction. RBI norms prescribe sector exposure for infrastructure to be no more than 20 per cent of total exposure of banks; but there is a great pressure for project debt, and banks have been pressing for a relaxation of these limits. There is shortage of capital for investments, as well as shortage of capacity for completing the projects.

Inflationary pressures caused by supply shortages in the real economy and by asset bubbles in the financial sector instruments are likely to complicate the adjustment process that the RBI is moving towards. It is important that the process of growth especially the construction of infrastructure be adequately funded, and at the same time there be some moderation in inflation.

A further imponderable is the re establishment of the National Advisory Council (NAC), headed by Mrs Sonia Gandhi. Even in the initial days, the signals from the NAC have been to enlarge the social content of programmes. The NAC has been at the forefront in attempting to push through food security legislation, and a reservation for women in Parliament. These are indications that social sector agenda may have a priority over economic reforms – a move that was hinted at in the budget speech, and is likely to put pressure on public expenditure budgets of the central as well as the state governments. The NAC is apparently quite concerned over the fact that over 45 million families have tried to access the NREGA programme last year, a clear indication that poverty levels are still very high in the country. Increasingly, there is a recognition that the benefits of liberalisation have not penetrated down to the bottom 20 per cent of the population.[6]

Interestingly, the Government appears to have taken the view that the RBI has to sort out these monetary dilemmas, and that it has enough dilemmas of its own. The Prime Minister's Economic Advisory Council continues to make anxious sounds in the background. But there appears to be little direction from them on what the RBI should be doing.

---

[4] From the Union Budget, 2010-11, Ministry of Finance, Government of India.
[5] IPL auction for Kochi team; read Indian newspapers of 12, 13 and 14 April 2010.
[6] See, for example, The Economic Survey 2010-2011, Ministry of Finance, Government of India, Chapter 1.

If the RBI decides to cool the economy through monetary tightening, then there would be consequences for growth. There would be some easing of inflationary pressures, though commodity prices and food prices would continue to be outside the control of this policy. Government may allow this tightening to happen, for inflationary pressures are beginning to be a worry even politically.

oooOOOooo