BW | BUSINESSWORLD

BW OPINION 21 Jul 2012

Goodbye To Diplomacy A Reserve Banker in retirement has given an unusually frank and alarming picture of policy errors and their dire consequences. But his main point is cloaked in government-speak

There was a time when Rakesh Mohan held interesting views and expressed them in a forthright manner. That got him into some trouble. His short stint in the finance ministry was not a success. But eventually, the masters of bureaucracy found a way of taming him: they made him deputy governor of the Reserve Bank. He was in charge of monetary policy, but also spent much time chairing meetings, posing with visiting functionaries and giving sermons to bank trainees. It was difficult to be rash in the funereal environment of the Reserve Bank; but just in case he might break out, Mohan was given a strong staff of a secretary and two research assistants to keep him on the straight and narrow path. The precautions worked; it is difficult to think of a memorable speech from Mohan in his deputy gubernatorial role.

Just as Mohan was in danger of being written off as another colourless member of the establishment, he has given an old-style interview to the Wall Street Journal. Its interest lies in the fireworks he set off. But it would be a mistake to dismiss it as the return of the firebrand. His criticism of the government and the RBI has substance; he has at last given everyone something to ponder over .

His central point is that although the RBI been depreciating the exchange rate at 10 to 15 per cent a year, it has lagged behind inflation, and that the real effective exchange rate has consequently appreciated. This has made exports uncompetitive and imports cheap; as a result, manufacturing industry has been crippled, and its growth has plummeted.

The collapse of the manufacturing boom is central to the fall in GDP growth. Industry was the first sector to begin slowing down; its growth has come down fastest. There is no getting away from the fact that we have entered an industry-led downturn. What Mohan has added is the explanation: mismanagement of the exchange rate is behind the decline of industry. If he is right, the slowdown has been induced by policy. The government made a mistake in exchange rate management that has already cost the country heavily, and will cost a good deal more

His point on capital inflows follows. Fear of rupee depreciation would dissuade foreign investors from bringing money in; conversely, appreciating the real exchange rate would be conducive to capital imports. The Reserve Bank liberalised foreign investment in government debt. It is not generally realised that such debt flows are highly volatile

Just like portfolio capital inflows, they can be quickly brought in and taken out. And the decision to invest or disinvest in government bonds is much simpler than in equity: investors take the decision on the basis of the rate of interest and their expectations of how the exchange rate and the interest rate will move. If the real exchange rate has become overvalued, it does not take a genius to work out that the government will eventually have to depreciate it, and to withdraw investments before that happens. So by liberalising investment in government bonds, the government has set the stage for a sudden outflow of foreign capital. It is extremely loath to let its foreign exchange reserves go down. So the reserves may just as well not be there as far as policy is concerned. If — when — capital starts flowing out, the government will depreciate the rupee in a panic, and no one can tell where it will go — whether it will settle at Rs 55, 99 or 111 to the dollar

Mohan's policy recommendations are more obvious, but not less important. He suggests a cut in diesel subsidy. It depends on how big the cut is, but it is unlikely to have much impact; the elasticity of demand for diesel is pretty low. He is in favour of taking money out of the rural employment programme and foodgrain subsidies and investing in rural infrastructure. The idea is obviously to make agricultural product markets more efficient and bring down costs; but the impact may be too slow for this government. His third idea is that the government should remove the bureaucratic hurdles which have held up infrastructure investments — for example, the ultra mega power projects. It is obviously a good idea; it has been around for some time, but the government seems to find it repugnant somehow

However, his main point was so cloaked in government-speak that it is likely to be missed: that the single-most important thing the government can do is to cut its fiscal deficit. The point cannot have escaped our finance minister pro tem. But he has politicians to please and elections to win; cutting expenditure is unlikely to figure amongst his priorities. But Mohan should speak out once in a while nevertheless; after all, he has nothing to lose.

(*This story was published in Businessworld Issue Dated 30-07-2012*)