

MONDAY INTERVIEW / DEEPAK NAYYAR

'Statistical jugglery does not change economic reality'

There is no evidence of buoyancy and success in the tax reforms. The present fiscal regime is not sustainable and the government has been fiscally irresponsible. Double digit inflation persists. The comfort implicit in the foreign exchange reserves is illusory and the BoP remain fragile. In sum, it would be a difficult economic legacy for the future government, says professor at CESP, JNU and former chief economic adviser and secretary in the ministry of finance Deepak Nayyar in an interview with Santanu Ghosh.



RBI at lower rates of interest and borrowing much more from the market at higher rates of interest. At the same time, the use to which the government is putting its borrowed resources is now worse than what it was in the second half of the 80s because it is using a much larger proportion of the borrowings to finance consumption expenditure. This is only postponing the day of reckoning by mortgaging our future.

■ **How substantial is the threat to the government from the increasing burden of interest payments?**

The persistence of the fiscal crisis and the mounting burden of internal public debt are closely related. If you borrow larger and larger amounts at higher and higher rates of interest to finance consumption expenditures of the government, and do nothing to increase the productivity of its investment expenditures, it should come as no surprise that interest payments as proportion of revenue receipts of the government will continue to rise in exponential manner. It is obvious that the government has been fiscally irresponsible. So much so that one begins to wonder about the rationality of some decisions. Consider, for example, the zero coupon bonds which the government has sought to borrow through. What you are doing is borrowing in the capital market at high interest rates where there are no interest payments or repay-

ments to be made for the maturity period of such bonds and a bullet payment is to be made for the interest accumulated and the amount borrowed, together, when the bond matures. This is going to make the life of successive governments extremely difficult.

■ **What explains the secular decline in the WPI measured inflation rate in the face of a rising CPI and increasing growth of broad money supply?**

The first point I want to make is that there is no causal relationship between the expansion of money supply and the rate of inflation as orthodoxy suggests. I believe the rate of inflation in India is determined much more by real economic factors such as supply-demand imbalances. It is also influenced by endogenous shocks such as bad harvests or exogenous shocks such as oil price increases. But for those who believe that it is money supply which causes inflation, as the government believes, there is a cause to worry. The reason is that the rate of expansion of money supply has been in the range of 15 to 18 per cent per annum in the last five years — no less, I must emphasise, then the unbridled monetary expansion in the second half of the 80s. The second point I would like to make is that statistical jugglery does not change economic reality. We can measure inflation in terms of the WPI or CPI, also

in terms of point-to-point rates or average-of-period rates. The government chooses different measures at different points of time to suit its convenience. The fact of the matter is that, even though the point-to-point WPI rate of inflation today is 5 per cent, in terms of any CPI that the government would like to choose, the rate of inflation is more than 10 per cent per annum. Even if we take the average annual rate of inflation in the WPI, the rate would be almost 10 per cent per annum. The harsh reality is that, over the past five years, the annual rate of inflation has been in the range of 10 per cent per annum. Hence, a basket of goods which cost Rs 100 five years ago costs about Rs 165 now and if that basket of goods is made up of rice, wheat, sugar and edible oil what cost Rs 100 five years ago would cost almost Rs 200 today. The woman in the household and the man in the street face this reality everyday.

■ **To what extent is the government's monetary management responsible for the recent depreciation of the rupee? Do you think RBI should have intervened when the slide began?**

In my judgement, the depreciation that we have seen in the exchange value of the rupee in this financial year has a lot more to do with speculative factors or adverse expectations, which are induced by govern-

ment policies, rather than by real economic factors. Most economists would recognise that nominal exchange rates need to be adjusted for differences in rates of inflation. On that account one might have expected some depreciation in the exchange rate of the rupee which was pegged at Rs 31 per dollar for quite some time despite the high rate of inflation in India. But once you introduce partial convertibility on capital account, say for repatriable deposits or portfolio investment, speculation and expectations in the market can exercise a strong influence on the exchange rate. This is something that every country which relies on portfolio investment to finance its current account deficit has come to realise. In order to continue to attract portfolio investment you have to keep interest rates high and exchange rate strong. After a while, the exchange rate begins to look overvalued and there comes a time when speculation against the currency mounts. This is borne out by the experience in Mexico not so long ago. It is not surprising that market expectation and speculative activity led to a sharp depreciation in the exchange value of the rupee.

■ **So far the government has been using direct instruments of monetary control to curtail inflation. What do you think about the use and effectiveness of indirect instruments, such as government securities?**

First, I am not persuaded that monetary expansion is the prime factor underlying inflation. Hence, I would worry much less about monetary aggregates than orthodoxy does. Second, in an economy such as India's the rates of interest and the availability of credit are going to remain, for some time to come, the most important instruments of monetary policy. Third, you can use open market operations only when government debt become marketable. In economies where internal public debt is rising rapidly and the burden of interest payment on public debt is enormous, I am not sure this will be an effective instrument.

■ **As the survey points out the decrease in the FII investments in 1995-96 in India was not in isolation from the general trend of decrease of FII investments in the emerging markets. Is this the precise reason for the slowing of the FII investments at present and if so why is trend in the emerging markets?**

There is a proverb which says: "Once bitten, twice shy". The experience of FIIs in Mexico and in some other emerging markets where they have burnt their fingers has been a salutary lesson. Such FIIs have become much more cautious about investing in so-called emerging markets or new markets. I believe that, for India, where convertibility on capital account for portfolio investment was introduced much too prematurely, the Mexican experience has turned out to be a blessing in disguise.

■ **According to the survey, the strength and resilience of India's BOP is largely due to the robust export growth. How resilient is our BoP scenario?**

The BoP situation at the end of 1995-96, is, in a fundamental sense, almost as fragile as it was at the end 1990-91. The reason is two-fold. First, we have stabilised the BoP and accumulated foreign exchange reserves by medium term borrowings. Consequently, the medium term and long term external debt of the government rose from \$63 billion at the end of March 1991 to \$85 billion at the end of March 1995.

The government has been able to reduce short term debt which I believe was both necessary and desirable. But medium and long term debt have grown by as much as \$22 billion in a period of 4 years. At the same time, the comfort implicit in the size of the foreign exchange reserves (which went up from \$2 billion at the end of March 1991 to \$20 billion at the end of March 1995 but came down to \$16 billion at the end of January 1996) is illusory because these foreign currency assets are more liabilities which have short maturities or can be withdrawn on demand. At the end of January 1996, foreign exchange reserves were \$16.3 billion. The short term debt with a maturity period of less than a year was \$4.5 billion. The par value of outstanding portfolio investment, without allowing for capital gains realisable and repatriable, was \$8.5 billion, so that these short term foreign exchange liabilities added upto \$13 billion, that is 80 per cent of the foreign exchange reserves. But that is not all. Repatriable deposits added upto \$12 billion. Thus short term debt, portfolio investment and non-resident deposits together were \$25 billion whereas the foreign exchange reserves are only \$16 billion. Are we really doing all that well in managing our BoP? I think not. The only silver lining to this cloud is that our export growth has been robust for the last 3 years. In my judgement, export growth is the only sustainable means of stabilising our balance of payments.

■ **According to the Economic Survey, the threat of external debt is not much since most of the debts are at concessional rates. Do you agree that we are in a comfortable situation as far as the external debt is concerned?**

I do not believe that we are in a comfortable situation. Just look at the facts. The total external debt of the country has risen from about \$84 billion at the end of March 1991 to \$99 billion at the end of March 1995. This makes India one of the largest debtors. Unless such borrowing from abroad is used exclusively to finance investment and the rates of returns on such investment are high enough to support interest payments as also to finance the possible depreciation of the rupee in the interim, the external debt could easily assume unmanageable proportions as in the recent past.

■ **To conclude, are you satisfied with the analysis of the survey on the fiscal and monetary fronts? What exactly are the potential dangers on these fronts?**

I am not satisfied with the analysis of the Economic Survey. It is much more a pre-election manifesto than a pre-budget Economic Survey that it should have been. In my judgement, it is instructive to compare the present economic situation with the situation that prevailed five years ago. First, the fiscal crisis is much deeper. Second, the BoP situation is almost as fragile. Third, double-digit inflation persists despite the concerted effort at stabilisation and five good monsoons in a row. Fourth, the prospects for growth in the medium term are meagre, in part, because the macroeconomic situation is untenable and in part because public investment in infrastructure has collapsed, while private investment is being squeezed by high interest rates and large government borrowing in the domestic capital market. In sum, I believe that this is going to be a difficult economic legacy for the government which would assume office after the elections.