Challenges facing India's growth in the new year

Dr. T. K. Jayaraman

The United States (US), the world's largest economy, with an annual output of $ 23 trillion and a per capita income of $ 62,000 and India, an emerging market economy (EME) with the annual output of $3.12 trillion and per capita income of $1961 finally seemed to have met with some measure of success in their fight against inflation. There are some more similarities: They both delayed their action on the questionable assumption that the signs of rise in inflation in late 2021 were "transient and transitory" and would therefore vanish soon (**Table 1**). They waited until May 2022, as their fond expectations did not materialise.

In the case of the US, the monthly targeted inflation (change in the domestic consumer price index (CPI) and calculated on a year-to-year basis) by the US Federal Reserve (the Fed), is 2%. However, it was exceeded much before December 2021, when US registered inflation was 7%. It rose to 8.5% in March 2022. The Fed had to increase its lowest ever policy interest rate from 0.25% to 0.50%, which was adopted ever since the Covid-19 pandemic began to ravage the world economies from the mid-2020 and well into 2021, with loss of lives and livelihoods. The Ukraine-Russia war, which began from February 2022, disrupted the supplies of petroleum crude and natural gas and wheat to Europe. The resultant increases in world commodity prices and the war related bottlenecks in supply chain resulted in unabated price inflation. The US inflation reached an all-time high of recent years, at 9.1% in June 2022, despite steeper increases in the policy rate by 50 basis points in May.

TABLE 1

Inflation and Interest Increases Rate

India			USA		
Year/month	Inflation (%)	Interest Rate (%)	Year/month	Inflation (%)	Interest Rate (%)
2021 December	5.66	4.00	2021 December	7.0	0.25
2022 January	6.01	4.00	2022 January	7.5	0.25
February	6.07	4.00	February	7.9	0.25
March	6.95	4.00	March	8.5	(March 16) 0.50
April	7.79	4.00	April	8.3	0.50
May	7.04	(May 4) 4.40	May	8.6	(May 4) 1.00
June	7.01	(June 8) 4.90	June	9.1	(June 15) 1.75
July	6.71	4.90	July	8.5	(July 27) 2.50
August	7.00	(Aug 8) 5.40	August	8.3	2.50
September	7.41	(Sep 30) 5.90	September	8.2	(Sept 21) 3.25
October	6.77	5.90	October	7.7	3.25
November	5.88	5.90	November	7.1	(Nov 2) 4.00
December	NA	(Dec 7) 6.25	December	NA	(Dec 14) 4.50

NA: Not Available

TABLE 2 (In %)

Assets of Reserve Bank of India : (2015-16 to Oct 2022)

Fiscal Year	Banking Department Rs. lakh crore	Issue Department Rs. lakh crore	Total Rs. lack crore	Change Percent
2015-16	13.4	17.0	32.4	-
2016-17	17.9	15.1	33.0	1.9
2017-18	15.0	21.2	36.2	9.5
2018-19	17.7	23.3	41.0	13.4
2019-20	26.4	27.0	53.3	30.0
2020-21	28.3	28.8	57.1	7.0
2021-22	31.5	31.1	62.6	9.7
2022-23	26.8	31.8	58.6	-6.4

Source: RBI Annual Report

With steady increases in interest rate by 75 basis points in subsequent months, the US inflation fell in October to 7.7% and 7.1% in November 2022. Market expectations in late November and early December 2022 was that the Fed would pause. On December 14, the Fed on the other hand, not only surprised the economy with an increase by 50 bps but stunned the economy by announcing "higher rates were still needed to fully tame the worst inflation about to strike the economy in four decades." The new rate is 4.5%, its highest level in 15 years. The US economists foresee a prolonged slowdown in growth due monetary tightening, as "rise in unemployment as the only way to fully derail inflation" and "only higher unemployment rate and declining wages" would reduce inflation pressures.

India experienced spiraling inflation since late 2021. All along until December 2021, it was higher than the target rate of 4% but was within the comfort zone, as it was below the upper tolerance limit of 6% (the target rate plus 2% margin). In January 2022, it touched 6.01%, breaching the tolerance limit and surged to highest at 7.79% in April 2022. The RBI had to increase the interest rate from 4% to 4.40.% in May and went on to increase by 50 basis points to reach 5.90% on September 30, which continued until Dec 7. As inflation for November fell to 5.88%, it was hoped that RBI would now pause. However, RBI's Monetary Policy Committee (MPC) raised the policy interest rate by 35 bps to 6.25%.

"Given the uncertain outlook, a pause may engender a situation where we may find ourselves striving to do a catch-up through stronger policy actions in the subsequent meetings to ward-off accentuated inflationary pressures. I, therefore, vote for an increase of 35 bps in the repo rate (from 5.90 per cent to 6.25 per cent) — a departure from 50 bps on three previous occasions — which itself conveys the signal of an improvement in the inflation outlook," RBI Governor Das said.

No more cheap money policy

Monetary tightening is underway in the US and India. The central banks of the US and advanced countries have been pumping in money to save their economies from the global financial crisis in 2008. Withdrawal of accommodative monetary support was not only slow but also delayed by the well-known 'taper tantrum' hesitation during 2013-15 years and in subsequent years in the US. When the Covid-19 pandemic struck the world, assets and liabilities were already high. The Fed's balance sheet was around $900 billion in July 2008, which bulged to $4.17 trillion by February 2020 and further to $8.7 trillion by December 2021.

Ultra-easy monetary policy contributed to more problems. A paper on "Central bank balance sheets in Asia and the Pacific: the policy challenges" by Jaime Caruana, former Chairman, Bank of International Settlements (2011), cautioned against the adverse effects stemming from expansionary policies on both real and financial sectors of the economy: they include financial instability and financial market distortions, creating conflicts in sovereign debt management.

Table 2 presents details of buildup of expansionary monetary policy as the RBI balance sheet reflects in terms of assets. During the Covid-19 pandemic years, both fiscal and monetary expansion gave rise to a huge rise in RBI's assets by 30% in 2019-20, when they were ₹53.3-lakh crore. Both 2020-21 and 2021-22 fiscal years witnessed a slower growth, at 7% and 9.7%. The Hindu Businessline reports that RBI's balance sheet has shrunk to ₹ 58.57-lakh crore as on October 28, 2022 by 6.45%.

The contraction is attributed to

- Use of foreign exchange reserves for arresting the rupee's sharp depreciation resulting in the decrease of foreign exchange reserves by 32%, amounting to ₹ 3.97-lakh crore.
- Improvement in bank deposits with RBI following the rise in CRR by 50 bps in May.
- A fall in RBI's holding of government securities from ₹14.17 lakh crore on March 31, 2022 to ₹13.9-lakh crore by end of September, an indication that RBI is reducing its stock of G-secs.

Risks facing policy makers

With the likely growing fiscal deficits by state governments and the central government in the coming year to support growth and job creation, internal risks must be faced. They involve public debt management. External risks would arise from rising high cost of imports of intermediate and capital goods due to appreciation of dollar following the US Fed's continuing anti-inflationary stance. The interest differential between India and other emerging market economies besides uncertainties caused by the ongoing conflict between Russia and Ukraine, would also make the US continue as a haven. The result would be a greater volume of capital inflows into the US would make the dollar stronger.

No doubt India had to face a triple whammy of low economic growth, high inflation, and till recently, a weakening of the rupee vis-à-vis the dollar and other major currencies 2022. The latest statistical data showed India's GDP growth decreased to 6.3% in Q2 FY23, with a significant contraction of 4% in manufacturing. The rupee has depreciated by more than 10% since January 2022 and is hovering around ₹ 82 against the dollar currently.

In mid-December 2022, India's Finance Minister told the Parliament that the country's foreign exchange reserves were again on the rise indicating increasing inflows through both foreign direct investment and investment and foreign portfolio investment routes, despite the RBI's intervention in the foreign exchange market to stem the volatility in rupee-US dollar movements. "As global spillovers from geo-political tensions and aggressive monetary policy tightening across the world intensified alongside a surge in crude oil prices, the US dollar strengthened by 7.8% in the FY (till November 30, 2022). The rupee depreciated by 6.9% in the current FY (till November 30, 2022). It has performed better than most Asian peer currencies, including the Chinese Renminbi (10.6%), Indonesian Rupiah (8.7%), Philippine Peso (8.5%), South Korean Won (8.1%), Taiwanese Dollar (7.3%) during the financial year", said the finance minister.

TABLE 3

India: Foreign Exchange Reserves and Exchange Rate : 2012 to 2022 -23

Calendar year	Foreign Exchange Reserves US$ billion	Exch Rate Rs/US$
2007	273	41.3
2008	254	43.5
2009	275	48.4
2010	298	45.7
2011	297	46.7
2012	298	53.4
2013	296	58.6
2014	323	61.0
2015	351	64.2
2016	360	67.2
2017	410	65.1
2018	397	68.4
2019	460	70.4
2020	586	74.1
2021	634	73.9
2022	565*	82.73

* Upto November 2022

India's foreign exchange reserves rose by $11.02 billion during the week ended December 2 as the central bank accumulated nearly $8 billion through FPI flows of short-term nature. At the current levels, reserves are reported to be adequate to cover around nine months of projected imports for 2022-23. The latest level is $81 billion less than the peak of $642 billion in September 2021 (**Table 3**). The overall performance of the rupee, in terms of US dollar, in recent months is better than that of other currencies. **Table 4** shows the movement on a month-to-month basis is the lowest in the case of India. However, the fears are still there that India's current account deficit (CAD) would continue to cause concerns, despite the optimistic assurance by RBI that a rise in services exports and higher inward remittances.

The Reuter news confirms the fears that CAD widened in the July-September quarter as high commodity prices and a weak rupee increased the country's trade gap. The CAD was $36.40 billion in the second quarter of fiscal year 2022/23, its highest in more than a decade. As a percentage of GDP, it was 4.4%, its highest since the June quarter of 2013.The RBI linked the widening deficit to the increase of "the merchandise trade deficit to $83.5 billion from $63.0 billion in Q1 2022/23 and an increase in net outgo under investment income". In its Financial Stability Report released after the data, it said the widened trade deficit reflected "the impact of slowing global demand on exports, even as growth in services exports and remittances remained robust".

TABLE 4

Changes in Exchange Rates of Emerging Market Economies in 2022 Month to month (percent) as of September 2022

Countries	%
Argentina	-5.7
South Africa	-4.6
Taiwan	-3.7
Thailand	-3.2
Philippines	-3.1
China	-3
Brazil	-1.7
Malaysia	-1.5
Turkey	-1.5
India	-0.8
Indonesia	-0.8
Mexico	0.5
Russia	2.0

Minus sign indicates depreciation of domestic currency against US$
No sign indicates appreciation of domestic currency

An earlier forecast by analysts outside RBI is that the rupee may fall to ₹ 85 a dollar soon.

Fixed exchange rate and capital controls

In these circumstances, there are some wild thoughts floating in the minds of many. One is about going back to the fixed currency and the other about imposing capital controls, for keeping the exchange rate constant. India is now a far more liberalised economy than what it was under permit-license Raj with restrictions imposed on private initiative and free market forces until the mid-1990s. Further, going back to a fixed exchange rate regime would require linking to a major currency in terms of units of that currency. That will create more complications as the world has moved away long ago in 20th century from the Gold Standard much earlier ("Two episodes of US inflation", Business Economics, Dec 1 2022). India cannot afford to be an exception, which would prove to be disastrous. If China could do it, it can do it because it is a one party/one man dictatorship, which is feared by the free world, because of both economic and military power. The euro or the British pound or the Japanese yen no longer is considered a substitute for the US dollar as all the three are under stress themselves.

> A paper by Professor Michael Klein on Capital Controls: Gates and Walls tells us about the difficulty with capital controls: global investors and markets are adept at finding ways around them. He cites the case of Brazil, which imposed short term capital controls after the 2008 crisis but it was found there was no discernable effect on limiting capital flows as the internet payment systems enabled investors to side-step traditional regulations.

Secondly, the capital controls of the variety adopted by former Prime Minister Dr. Mahathir bin Mohamad of Malaysia are not one hundred percent of the conventional type. Under his leadership, the exchange rate was fixed as 3.8 ringgits to US$ 1 to handle the catastrophic effects of the Asian Financial Crisis (1997- 1998), as Malaysia saw a huge amount of capital leaving the country, resulting in heavy depreciation of the ringgit.

Malaysia's capital controls were of "one way kind": no controls on capital inflows but only on capital outflows. That is: you can check- in but you cannot check-out, of "the roach-motel kind." To get rid of cockroaches, the American supermarkets had popularised an item for their customers to help prevent them from invading the kitchen by putting poisonous bait in an attractive box, but they cannot emerge alive once they taste the bait! Can such capital controls of "get-in but no get-out" work in a more liberalised world after two decades? The world, including India has seen the benefits of freer flow of FDI along with smooth transfer of technology and skills. In the process they also helped their currencies to appreciate/stabilise and obtain imports at cheaper costs. If one country adopts the roach-motel methodology, other countries who do not resort to such methods, would be favoured by overseas investors. Only, sound economic policies aiming at price stability would help in the long run. In other words, healthy macroeconomic indicators achieved through prudential fiscal and monetary policies over time would make the country safer and secure from global cycles of expansion and recession.

A paper by Professor Michael Klein on *Capital Controls: Gates and Walls* tells us about the difficulty with capital controls: global investors and markets are adept at finding ways around them. He cites the case of Brazil, which imposed short term capital controls after the 2008 crisis but it was found there was no discernable effect on limiting capital flows as the internet payment systems enabled investors to side-step traditional regulations.

One alternative is encouraging the formation of currency blocks of countries whose intra-trade is of sizeable nature enough to settle payments in the currency of the major trading partner rather than in US dollar. About 35 countries who have substantial trade with India have already shown interest in the formation of a rupee block. They include neighbours such as Sri Lanka, Bangladesh, Nepal, and Myanmar. These countries are grappling with a shortage of dollar reserves. Efforts are underway. The central government and RBI have initiated special drives about settling bilateral trade in the Indian currency rupee and some leading Indian commercial banks have opened special rupee accounts with Indian and foreign exporters and importers. The latest press reports say 18 such special rupee accounts have been opened by 11 banks, which include those of Russia. Mauritius and of Sri Lanka. Thus overseas trade in rupee would safe guard external sector from exchange rate fluctuations. ■

— Dr TK Jayaraman, a former staff of Asian Development Bank, is a Visiting Research Professor, Faculty of Business, Accounting, Finance and Economics at University of Tunku Abduk Rahman, Kampar, Perak State, Malayisa. He is also the Honorary Adjunct Professor, Amrita School of Business, Bengaluru Campus. The views expressed are the author's own.