TELEGRAPH SEPTEMBER 16 2013

CONTRADICTORY ACTIONS

- The complex tasks for the new governor of the RBI

Commentarao: S.L. Rao

The rupee appears to have dithered in its precipitate fall. The new governor of the Reserve Bank of India has taken a position with strong and clear statements of what he sees as his tasks. The ugly public disagreements expressed by the prime minister and the finance minister with the RBI hopefully will not be repeated. Nor will there be different statements from the government and the RBI on the rupee exchange rate.

The government has announced some half-measures. They are to get stalled infrastructure projects moving. A comprehensive package that will make them move does not appear possible in this un-coordinated governance. The expensive and inefficient food security legislation is in place. So is the new land legislation. The first will add to the deficit, corruption and inefficiencies. The second will be another hindrance to private industrial investment. The apparent small but clear recovery of the American and European economies is a good sign. The blaming of external events for the fiscal and current-account deficits on external events will cease and the focus will be entirely on domestic measures.

This article looks at the complex and contradictory tasks before the new governor of the RBI. Greater availability of finances, interest rates, the rupee’s exchange value, domestic investment, the twin deficits, foreign fund inflows, and the overhang of corporate external debt are the principal challenges. The government has announced the forthcoming issues of tax-free bonds by public-sector undertakings, amounting to Rs 58,000 crores, with tenures up to 20 years and interest rates as high as 8.71 per cent. For high net-worth individuals paying marginal rates of tax of 30 per cent, this would amount to a return of 11.48 per cent before tax. What is more, the bonds can be traded. There may be more of these in the coming months.

The government and RBI have to control inflation. Analysts think it unlikely to moderate very much despite the good monsoon, because of rising energy prices. In recent months, the RBI has put pressure on liquidity, and maintained high interest rates. The RBI might now, and frequently, increase and reduce liquidity while holding on to interest rates.

Banks are already under pressure, especially because substantial infrastructure loans (in projects with bank financing at 66 to 80 per cent of project costs) have come for restructuring or even becoming non-performers. The strong message to banks now is to penalize defaulters and closer scrutiny of loan applications. This will raise bank balance sheets, and improve matters. Banks must carefully examine project contract terms and the assumptions behind the quotations made in the bidding. The defaults have been mainly in road projects initiated power and metro projects. They are delayed, tying up massive funds (around Rs 2,80,000 crores are up for loan restructuring). Causes for delays include more than anticipated delays of clearances from government departments (environment, forests, relief and rehabilitation, rises in fuel costs, huge rupee exchange value fluctuations, and so on). They were beyond the assumptions of project developers. The government departments concerned have not compensated for the losses suffered because of the delays. In public-private partnership contracts, lenders did not adequately scrutinize the contract conditions, and the bid term, which was usually for 'levelized' tariffs over 25 years or more. These costs, because of long delays, made the projects unviable at the contracted tariffs. In future, the tariffs should not be for longer periods than required for bank financing and an independent body must examine renegotiation.

The availability of foreign funds might improve as Western economies recover. But they will no longer be as cheap as they have been, and of which Indian industry piled up debts of around $250 billion. Because of high deposit and lending rates, Indian companies should look for equity investments rather than the debts.

The tax-free bonds (more might be on issue in coming years) will also draw away some of the savings from the market, mostly from bank deposits, and put pressure on funds. This could adversely affect liquidity. There may be more such bonds to come. Their interest rates might also set a floor for deposit rates. It would mean a rise in bank deposit rates and therefore of lending rates in future months.

The government has to assure its own long-term funding. The attempt will be for the government to manage its massive social programmes and infrastructure spending without selling securities and adding to its deficit. Issuing the bonds by public sector units is one route. But how will the government use the funds from these PSU tax-free bonds?

We must expect that the RBI will be flexible on cash reserve ratios in attempting to improve liquidity. But interest rates may not decline. The RBI has to walk a tight rope to restrain inflation and stimulate investment. There is also the possibility that long-term capital costs will rise. The new governor mentioned the need for long-term financing to be separated to some extent from banks. Are we going to see revival in a different form of the old-term lending institutions?

India probably erred in past years in allowing companies the relative freedom to borrow abroad. Then the Indian economy was doing very well in contrast to Europe and the United States of America. Some European countries cut government spending and were in economic decline (like Greece and Spain). Others like the US were trying to grow their economies and employment through 'quantitative easing', that is, easy liquidity and low interest rates. This resulted in huge surplus and footloose funds looking for better returns. An obvious destination was the emerging countries. India figured prominently. Indian companies took advantage of the funds availability at low cost, to borrow heavily. Indian external commercial borrowings crossed $250 billion, (about the size of India's foreign exchange reserves), mostly repayable in 2014 unless rolled over. With the rupee-dollar exchange rate declining over 20 per cent in the last two months, these borrowings have made a big hole in Indian corporate balance sheets, except for companies with substantial export earnings.

Now that Western countries are on the recovery path, easy and cheap money will be history. Cheap foreign borrowings by Indian companies will gradually vanish. If the Indian economy and Indian companies are seen as risks (because of slow growth, weaker balance sheets and the declining rupee) the funds will not be available. The high balance of payments deficits will put pressure on the rupee. In this situation, companies should not be raising borrowings abroad because the rupee liability will rise. With domestic liquidity not easing by much because of continuing inflation, Indian companies could become starved for funds. Capital investments will also be hurt since the ordinary investor will prefer to keep his money in tax-free bonds, bank deposits, and safe company deposits.

Public investments will also be on a low keel since the government must make every effort to cut its deficit. It can do so by suspending or sharply reducing expenditures on the lavish social welfare schemes introduced by the Congress president. After the elections in 2014, the party or parties running the government will have to follow this course.

For economic and employment growth, there has to be a spurt in public and private investment, a curtailment of the government deficit, some improvement in liquidity, and the rupee must remain stable. Exports must be stimulated, for example, of iron ore and imports curtailed because of the high prices. Government seems to be applying itself to these. Bureaucratic and labour law hurdles to industry must go. Interest rates will remain high and rise for foreign funds. Liquidity will ease. Rupee values may stay at present levels.

Some issues require contradictory actions. The RBI and government must be proactive, quick in action, and unafraid to reverse course when changing conditions need it.

The author is former director general, National Council of Applied Economic Research