

Don't blame the RBI for economic ills



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There is ample reason to be miffed with the RBI for the 50 basis point rate hike in its last monetary policy review. The move has been the subject of debate among economists and market players; who believe that it will adversely impact business sentiments and the already fragile investment demand.

It could be validly argued that it was too late in the day and that the RBI should have been more aggressive in its tightening work the previous year, when the growth prospects seemed better, and not

now, when the growth is tapering off. The RBI's inflation forecast for March 2011 was grossly underestimated, given the prevailing inflationary pressure in the system. But the central bank cannot be solely blamed for misreading inflation and giving preference to growth over inflation as its policy decisions have been based on a set of largely unreliable/provisional data.

In fact, the persistently high inflation is also a corollary of government policies on the minimum support price, excessive dependence on credit for GDP growth and competitive currency devaluation policy adopted by the central banks in the developed world.

MSP FOR FOOD-GRAINS

The entire operation of minimum support price is conducted at least 3 tiers above what can be considered as farm-gate price for the poor farmer. Traders and rich/big farmers are the real beneficiaries of this massive fiscal initiative.

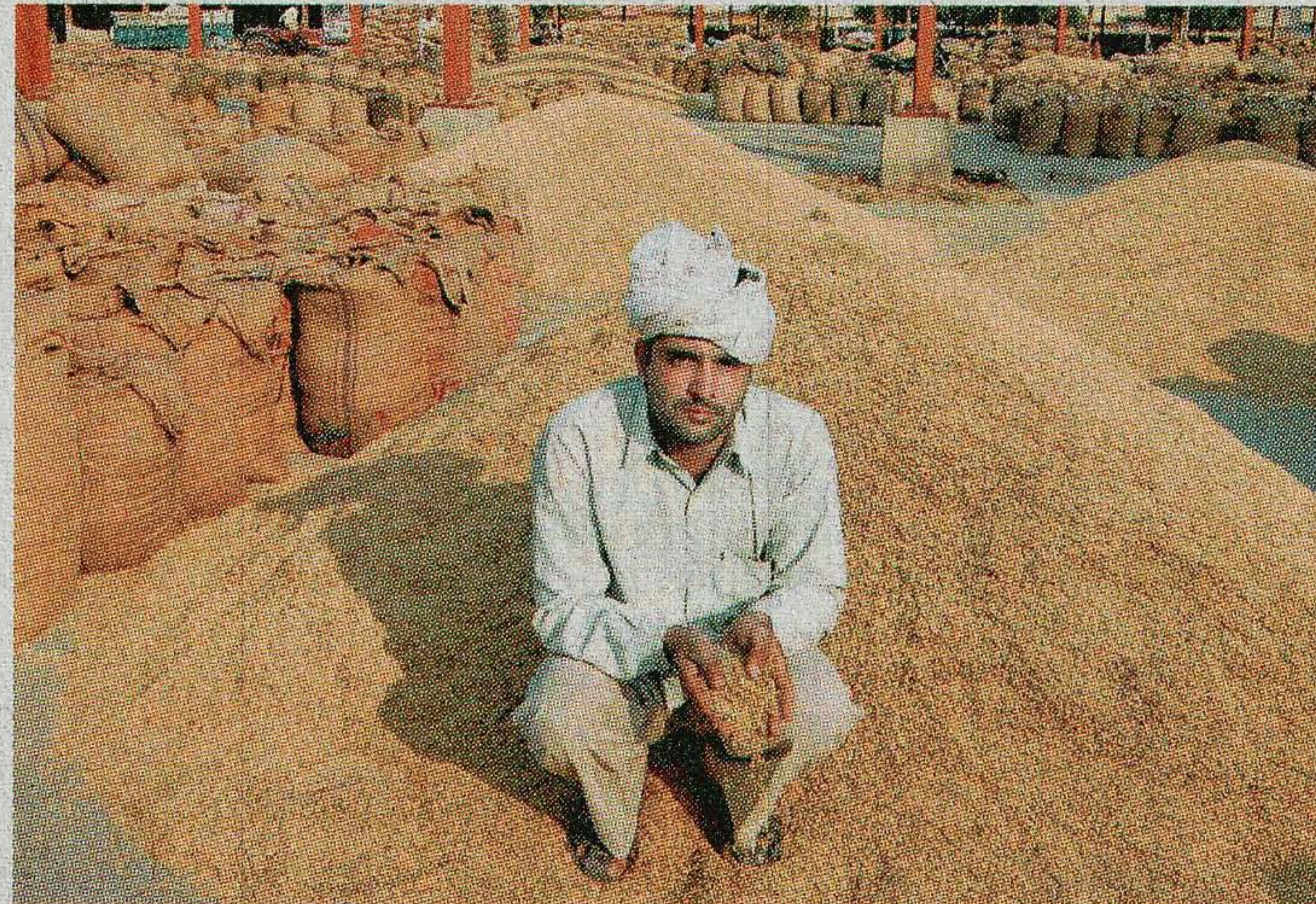
The process of disproportionate creation of wealth by them is further abetted by the "stocking" operation of the Food Corporation of India (FCI), which removes nearly 25-40 per cent of the supply from

the system. The disproportionately higher wealth acquired by traders and rich farmers has resulted in an explosion of unaccountable money in the system, which is expected to further fuel inflation either by way of a rise in asset prices (mainly land) or by creating enough ways to accentuate the shortage created by FCI.

BANKING CREDIT

Since the middle of the last decade we have become excessively dependent on credit to fuel GDP growth. This is manifest in explicit targets for growth in broad money (M3) that should enable 8-9 per cent real GDP growth. At a slightly lower level this translates into aggressive lending by banks.

Due to lack of appetite for incremental loans among big borrowers, banks had to push loans in the retail, mortgage and infrastructure segment. This has led to huge amount of money getting channelled into the hand of developers and almost a ridiculous surge in fixed assets of infrastructure companies in spite the anaemic order book — showing how rapidly money is being diverted from acceptable mainstream activities.



The minimum support price operation is conducted in a way that benefits the rich/big farmers more.

Additionally the competitive devaluation policies adopted by countries such as US through quantitative easing, Switzerland by cutting rates and Japan by cheapening the value of yen is moving money into both soft and hard commodities, adding to inflationary pressures in the economy.

These linkages ensure that money moves from economic producers to fixers and speculators leading to

rise in speculative activities. Speculative mindsets have become endemic as people believe money can be made by buying and holding real/financial assets long enough.

Inflation is a natural outcome of this "buy-and-hold" binge. This inflation cannot be controlled through rate hikes but requires sustained reforms to effect a change in mindset. Uncontrolled inflation of this nature has the potential to de-

stroy business competitiveness, further reducing job availability significantly.

Given these realities and government's reluctance to reform agriculture, we have seen a growing tendency to make up with handouts — MGNREGA and similar avatars. These initiatives may prevent the unemployed and under-nourished from revolting; the latter being felt in some parts of the world. However, it is leading to enormous government borrowing, as taxes are insufficient to pay for these handouts, leading to rising fiscal deficits.

In totality, a relief is provided by the government to poorer section by way of social reform schemes, while richer section is benefited from rapid increase in asset prices. However a broader representative of population — the middle class — has remained untouched by the benefits coming out of high economic growth, while at the same time it paid the most for elevated inflation by way of higher cost of living. Given this, the central bank's aggressive moves to tame inflation, even at the cost of growth in the near term, is appealing.

India's domestic saving rate of 33-36 per cent in recent years has

contributed considerably in achieving high economic growth. In India around 94 per cent of savings are in form of bank deposits. Saving is a function of positive inflation-adjusted real interest rates, while there has been an environment of negative real interest rate recently.

HIGH RATE FOR MORE SAVING

Thus, in order to maintain savings at higher levels, there is an absolute need of keeping interest rates high in the wake of high inflation, so as to support the savings appetite in the system and stop diversion of this money for consumption purposes, further accentuating demand-side inflation.

Our "demographic dividend" is creating enormous pressure in the face of reduced job availability. The declining job availability combined with increasing "financialisation", big fiscal deficits and powerful speculative mindsets may lead us down the same path that America took prior to the 2008 sub-prime crisis or East Asia took prior to the 1997 Asian crisis. We hope we don't reach the same end.

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