EAC seeks inflow curbs, free Re run

Need To Remove 'Administrative & Procedural Impediments' To Overseas Acquisitions

Our Bureau
NEW DELHI

RIDING an investment boom, the Indian economy will grow 9% in the current fiscal, on top of the 9.4% growth registered last year, and price rise will be contained at 4%—so says the Prime Minister's Economic Advisory Council (EAC). To pull off this feat, however, the economy's managers will need to make some tough choices such as curbing the inflow of external debt, allowing the rupee to appreciate further, and removing "administrative and procedural impediments" to overseas acquisitions. The EAC has also made some oblique criticism of the present accounting practice in public finance, which understates the combined fiscal deficit of the Centre and states by around 2% of GDP.

The panel's prognosis is more bullish than that of the Reserve Bank of India (RBI), which has pegged growth at 8-8.5%. It sees the external environment as still being benign and expects sustained investment to keep growth booming.

The need to curb capital inflows comes from the mismatch between the current account deficit (likely $17.4 billion) and surpluses on the capital account (likely $58 billion). The excess inflow of foreign capital into reserves, to the tune of $40 billion, can make the rupee far too strong, jack up money supply to create inflation, and/or push up domestic interest rates when the central bank tries to mop up excess liquidity by selling government bonds. A sensible policy response is to allow all these three things to happen in moderate doses and to discourage external borrowing for rupee expenditure within the domestic economy.

The council is not in favour of disrupting inflow of external investment into equity. "Equity investment by its very nature is high risk and policy continuity is an essential element to initiate and maintain such flows. They cannot be turned on and off at will," the EAC said.

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Three instruments to face capital flow

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HOWEVER, on the debt side, there are some areas that can do with some scrutiny," the council said.

The EAC has suggested three instruments to face the strong capital flow—allowing the rupee to appreciate; sterilising capital inflows in excess of what can be absorbed into reserves without pushing money supply growth above 17.5%; and instituting a policy of encouraging capital outflow and discouraging external borrowing for rupee expenditure.

"Instead of arguing for the exclusive use of any of the instruments, there must be a judicious mix of all the three. There are limits to which each instrument can be used by itself," EAC chairman C Rangarajan said.

While the rupee should be allowed to appreciate, Mr Rangarajan also cautioned against the possible fallouts. "There are limits up to which this can be done. Beyond a point it will hurt exports, as also the larger domestic economy. Besides, we need to take into account the behaviour of the currencies of other developing countries, most notably China."

The council's report has said farming is likely to grow by 2.5%, industrial output 10.6% and services 10.4% in the current fiscal. It expects inflation to remain close to 4%.

Mr Rangarajan cautioned that unless the farm and power sectors grow, the current rate of economic growth cannot be sustained. "Food security is an extremely important issue. Agriculture should be priority as 60% people are dependent on it."

Commenting on the power sector, he said if adequate attention is not paid to augmenting infrastructure, particularly power supply, overheating might persist on account of productivity and supply constraints.

The issuance of bonds to oil companies and the Food Corporation of India to meet their subsidy bills and piling up huge unpaid dues to the fertiliser industry help the fiscal deficit look more attractive than it actually is. At the state level, losses of PSUs serve the same purpose. While in the current accounting practice, these don't show up as part of the fiscal deficit, these items, adding up to around 2% of GDP, are part of the public sector borrowing requirement along with the fiscal deficit as conventionally defined.

The deficit, as per this wider measure, would still be a large 8.3% of GDP in 2006-07 and 7.2% of GDP in 2007-08. The Sixth Pay Commission award could widen it further.