India has big problems that lie well beyond Rajan's reach

Food-led inflation cannot be checked by monetary policy, writes Swaminathan Aiyar

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August 12, 2013

Great jockey. Pity he doesn't have a better horse. Raghuram Rajan, the former International Monetary Fund chief economist, will be the next governor of the Reserve Bank of India. He gained fame by warning about the global build-up of financial risk well before the 2008 meltdown. But his new job will test him. The rupee is crashing, inflation is high, the current account deficit is as wide as the Ganges in flood and both industry and exports are stagnating.

A year ago, after three years of policy paralysis and slowing economic growth, rating agencies threatened to downgrade Indian paper to junk. To avoid that Palaniappan Chidambaram was recalled to the finance ministry to spearhead a new round of economic reforms, including liberalised foreign direct investment rules.

He slashed the fiscal deficit from 5.8 per cent of gross domestic product in 2011-12 to 4.9 per cent in 2012-13. He hoped fiscal rectitude and reforms would attract dollar inflows, stabilise the rupee, anchor inflation and enable the RBI to cut rates in 2013, sparking an industrial revival.

This plan was on track until May. Foreign investors poured more than $20bn into Indian equity and debt markets, and the RBI cut interest rates three times. But then Ben Bernanke, US Federal Reserve chairman, hinted at a slowdown in quantitative easing. Billions of dollars flooded out of emerging markets in search of higher US yields – and India was no exception.

The rupee crashed; the RBI raised short-term rates to stem speculation against the rupee, but this also hit longer-term rates, reducing already-slow industrial growth. High inflation has eroded India's competitiveness as an exporter, driving the current account deficit to 4.8 per cent of GDP in 2012-13. This leaves India highly vulnerable to adverse foreign winds. A depreciating rupee may in the end help exports, but it immediately worsens inflation.

What can Mr Rajan do? As head of India's Committee on Financial Sector Reforms in 2008, he called for an independent RBI focusing on one target alone – low, stable inflation. This was contrary to the RBI's historical habit of trying to manage the exchange rate and GDP growth too. The committee warned that by trying to do too many things at once, the RBI risked doing none of them well – exactly the advice one would expect from a Chicago professor such as Mr Rajan.

But Mr Rajan is now Mr Chidambaram's chief adviser. Abandoning his Chicago robes, he now agrees with the minister's desire for lower inflation, a stable exchange rate and higher GDP growth all at the same time. Mr Rajan has backed the RBI's contradictory struggle to curb speculation with higher short-term rates and encourage Indian industry to invest more.

As it happens, inflation would not, in any case, be an easy target for the RBI. Central bankers the world over know they cannot control the prices of food and fuel. But food accounts for half of India's consumer price index. Food inflation is also institutionalised since the government raises the support price for several crops every year. Food-led inflation cannot be checked by monetary policy: higher interest rates tend to hurt industry more than they reduce inflation.

Mr Rajan and Mr Chidambaram have also sought new ways of financing the current account deficit: these include quasi-sovereign bonds issued by government corporations, more liberal corporate borrowings and a bond issue reserved for overseas Indians. But financing the huge deficit is not enough: the deficit must be cut. Otherwise, the rupee could keep sliding, and inflation keep rising. Alas, despite the weak rupee, exports are not growing.

The new governor will, however, be able to implement some of the other liberalising measures that he suggested in 2008. He favours much more financial competition and bank licences. He supports the slashing of red tape across the entire financial sector, the creation of many more financial instruments and an end to frequent bans on some sort of trading or another.

Much of this wider agenda will have to wait until the election in May next year, which will almost certainly bring in a new government. Will that improve the climate for reform? Alas, all jockeys know that a new owner is no guarantee that the horse will run faster.

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