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India must cut fuel subsidies to turn tide

By Komal Sri Kumar

Measures taken by central bank are helpful but not sufficient

Raghuram Rajan, the new governor of the Reserve Bank of India, surprised India watchers last month when he raised a key interest rate for the first time in almost two years. The sharp slowdown in economic growth, and the US Federal Reserve's decision to delay tapering bond purchases, had led financial markets to expect stable Indian interest rates.

Investors should not have been surprised. While the rate hike was seen as a means of controlling the stubbornly high inflation rate, there is an additional significance that has largely been missed by analysts.

RBI's latest move is part of a series of measures Mr Rajan has introduced to increase the role of the price mechanism, and to diminish the importance of administrative controls, in determining capital flows and the availability of credit in the Indian economy. This is in contrast to the Fed's zero interest rate policy, which has sharply limited the role pricing plays in determining credit demand and bank lending.

RBI's market-friendly moves include a partial reversal of capital controls that had been imposed to limit capital flight by residents, and investments abroad by Indian corporations. At the same time, banks receiving dollar deposits from the Indian diaspora were encouraged to swap them with the central bank at favourable terms, with the assurance that they will be able to get them back when needed. It was not surprising that, despite the partial lifting of controls, the rupee appreciated in reaction to the new incentive.

In a second move, RBI plans to issue new licences to raise competition in banking, and to increase the flow of credit to needy sectors. Foreign bank participation in the Indian economy will be encouraged. The prior policy had been to limit the number of banks and, instead, direct the flow of credit through administrative diktats.

Inflation-linked investments

Third, RBI has promised new investment instruments whose returns will be indexed to the consumer price index. The previous plan had been to index the instruments to the wholesale price index, where the weight given to food and fuel – important elements in the consumer basket – is much lower. By indexing to the CPI, the proposed securities should channel savings toward productive investments, and boost economic growth.

If residents are persuaded that CPI indexation would provide them with an effective hedge, the government may finally have succeeded in diverting savings away from gold. In the absence of appropriate investment instruments, gold purchases by residents have worsened the balance of payments, and weakened the rupee, at a time when fear of Fed tapering was already causing foreign investors to withdraw funds.

While these fresh initiatives by the central bank are welcome, they may not be sufficient to reverse prospects for the Indian economy. Two key measures can help.

First, subsidies on fuel, estimated at $23bn-$27bn annually in recent years, should be scaled back, reducing the budget deficit as well as the shortfall in the current account of the balance of payments. Even though reduced subsidies for domestic energy use are likely to further slow economic growth in the aftermath of their introduction, more efficient use of energy, and the improved fiscal situation, will eventually be positive for the economy.

While this unpopular measure will probably not be introduced in a big way before nationwide elections expected by May 2014, it should be top of the agenda for the new government.

Second, rules governing foreign direct investment in the country should be liberalised to increase the inflow of stable, long-term money.

The government has taken measures to resolve longstanding tax disputes with foreign companies with Indian subsidiaries, and this is a promising move. Clearer investment guidelines, authorisation of increased foreign ownership in "non-strategic" sectors, and a rapid approval process could ensure a more stable rupee in the long run.

Confidence boost

Finance minister P. Chidambaram told the FT last month that he would push for increased foreign investment in the insurance sector. That, and additional approvals in the retail and telecommunications sectors, could go a long way to boost investor confidence.

The recent market-friendly moves are a silver lining in the cloud of this year's rupee crisis. There are two important takeaways for investors. The new measures allow a freer interplay of supply and demand forces, and reduce the threat of sudden switches in government policy. Just as important, the increased transparency implies a lowering of India's sovereign risk.

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