

## Money Order

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India can match or surpass the economic success of China with a proper growth strategy. Such a strategy would have three facets: export led growth, rural improvement and macroeconomic stability. This article takes a closer look at the last of these, macroeconomic stability.

The present east Asian economic crisis highlights the vulnerability of even the most successful economies to macroeconomic instability. Perhaps it's even more accurate to say the most successful economies run the risk of a special kind of macroeconomic stability, a kind of crisis of success.

While the east Asian crisis is sometimes characterized in the world press as a massive failure of Asian capitalism, it is more accurate to say it is a failure of global capitalism to provide for a smooth and reliable flow of capital from the capital rich to the capital poor regions. And that failure is most acute in fast growing economies. India, therefore, must combine its growth strategy with special attention to the preservation of macroeconomic stability.

Here are some of the pertinent lessons for macroeconomic management.

First, beware of the reliance on short term inflows. Such short term capital is fickle. India has benefited since the early Nineties in keeping a regulatory restraint on short term borrowing from abroad. This was a consequence of its brush with financial disaster in 1991, a crisis which involved the reversal of short term capital flows of nonresident Indian accounts. There is simply no good case for allowing domestic banks to expose themselves to large amounts of foreign debt, especially short term debt.

Second, policymakers should keep an eye on the crucial ratio of short term debt to foreign exchange reserves. Markets will be subject to panic when short term reserves dip below short term debts. Again, India has looked rather good on this score in the recent past. With reserves around \$25 billion and short term debts to international banks around eight billion dollars, India therefore has a ratio of short term debt to reserves of around 30 percent, easily low enough to avoid a self-fulfilling panic. In comparison, the ratio stood at over 100 per cent in the east Asian crisis countries.

Third, India should act with consider able care in liberalizing financial markets. This is not an argument to avoid needed reforms, but to sequence them in an appropriate manner. Certain reform should come early. Currency convertibility on current account transactions can be introduced immediately- as was done successfully in Poland in 1990- since this merely establishes the financial mechanism for free trade. Similarly, the doors should be thrown wide open to foreign direct investment. FDI brings huge advantages like new capital, technology; managerial expertise and access to foreign markets with little or no downside FDI flows tend to be acyclical or some times even countercyclical.

Also, financial institutions should be pressed to raise capital in order to put a larger cushion in the financial system against the kind of banking calamities now hitting the east Asian countries. Undercapitalized banks are simply an invitation to banking misbehaviour and a heightened risk of banking collapse. State banks should be privatized, with an explicit aim of bringing in long term foreign investors into the banking sector. Another lesson from east Asia is that there are significant advantages to a large presence of foreign owners in the banking system. Foreign capital in the banks provides another cushion against collapse. For example, when the Indonesian banking sector collapsed in November 1997 the only banks that remained functional were the branches of international banks.

Fourth, India should avoid another of the serious mistakes of several east Asian countries, most notably South Korea, the Philippines and Thailand. These countries pegged their currencies to the United States dollar in the early Nineties. They then experienced inadvertent and sharp currency appreciation *vis a vis* Europe and Japan when the dollar strengthened after 1995. After that they ran down foreign exchange reserves vainly trying to defend the overvalued exchange rate when market sentiment turned against the currencies in late 1996 and the first half of 1997. By spending reserves in a failed defence of the currency, the central banks also left their economies exposed to subsequent financial panic when short term debts came to exceed the dwindling level of foreign exchange reserves. In the end, the currencies collapsed anyway, but only after a deep financial crisis had already gotten underway.

Fortunately, the Reserve Bank of India has been more circumspect in exchange rate policy, letting the rupee weaken in the face of the Asian crisis. There is probably more currency weakness to come, if only because India competes with Indonesia and Thailand in several product lines and thus will face pressures on cost competitiveness now that its competitors' currencies have been deeply depreciated.

Fifth, and perhaps most urgent for India, is fiscal restraint. Unless substantial fiscal consolidation is achieved, in our view, continued fiscal deficits pose India's greatest risk to future destabilization. Despite several years of fiscal consolidation effort, large and persistent fiscal deficits remain. Revised figures of major deficit indicators for the fiscal year 1997-98 bear testimony to the fact the fiscal situation has not been brought under control. As a matter of fact, except for the first year of fiscal stabilization, that is, when the fiscal deficit was reduced from 8.3 per cent of gross domestic product in 1990-91 to 5.9 per cent in 1991-92, performance on this front has been disappointing. As against the original scheme of reducing the fiscal deficit to around three per cent by 1996-97, the actual fiscal deficit for the year 1996-97 turned out to be as high as 5.2 per cent. Furthermore, the fiscal deficit in 1997-98 was even higher at 6.1 per cent.

India's overall government spending, currently around 33 per cent of GDP-Centre and states together-will need to be brought down substantially as a proportion of national product for India to achieve its reform goals of macroeconomic stability and long term rapid growth. We believe that deficits should be brought under control mainly by cutting government expenditures relative to GDP rather than by raising revenues relative to GDP.

In the final analysis, fiscal control will require an overhaul not just in budgetary patterns but in the basic functioning of the public sector in the economy. The privatization of infrastructure services is

a key way to relieve the growing burden on state budgets, which are heavily weighed down by losses of state electricity boards and other parastatal institutions. Greater autonomy for local and state level governments in infrastructure reform and investment priorities will similarly allow the Centre greater freedom in cutting back on transfer payments to the states. They, in turn, will be in a better position to prioritize and economize on state spending. Until India resolves to push even farther in market reforms, the soft budget constraint of the public sector will continue to spill over into large public deficits and a growing burden of public sector debt.