THE TUESDAY INTERVIEW/ DEEPAK NAYYAR

'Planning is essential'

DEEPAK Nayyar left his post as chief economic adviser in the finance ministry last December, to return to academia. In the first part of this interview, published last Tuesday, Nayyar said that differences on policy issues had prompted his decision to leave, although there were other considerations too. In this concluding part, Nayyar elaborates his views on macro-economic adjustment, with special reference to the current Indian experiment.

Q: The trend of opinion today is against too much intervention by the government, and greater reliance on market forces. Comment?

A: The zeal and enthusiasm for reform among the literati and the influential, reflects the mood of the moment. The sentiment associated with this mood has, perhaps, been strengthened by the collapse of the economic system in the USSR. We appear to have moved from a widespread belief that the state could do nothing wrong, to a widespread conviction that the state can do nothing right. These are caricature perceptions. The reality is more complex than simplified paradigms that may be in or out of fashion.

There is neither magic in the market place nor divinity in the invisible hand of the market. There is as much evidence of market failure as there is of failure in state intervention. In India, we are far more familiar with the latter than with the former. But instead of jumping to over-simplified conclusions, it is essential to recognise that markets can only serve those who are part of the market system. In rural India, 200 million people who eke out a bare subsistence, or live in absolute poverty, are not even remotely integrated with markets. For an economy at our levels of income and development, there is a vital role for the government. Planning is essential. So is state intervention, although there is a clear need for change in the nature of this intervention. Sukhamoy Chakravarty used to say that the market is a good servant but a bad master. We would do well to remember his wisdom, lest there be a confusion between means and ends.

Q: There has been some debate about making the rupee freely convertible. How do you react to this?

A: Yes, speculation abounds on this. It is almost like the chant of a mantra. But it sounds strange, if not bizarre. For one, any attempt to make the rupee convertible now, when the fiscal imbalance is large, the balance of payments is in crisis, and the rate of inflation is high, would be a recipe for certain disaster. For another, even if we abstract from the present conjuncture, the convertibility of the rupee would be sustainable only if it comes in a phased transition. In much the same way as a child must learn to walk before it can run.

Q: What kind of transition would you have in mind?

A: In my judgement, the transition should be in three distinct phases. First, we should make the rupee convertible on the trade account over a period of three to five years, for which the exim scrip provides a transition path. Second, we should then move to convertibility on the current account transactions other than trade, where the rupee is not convertible at present. Third, and this can come only after a time when there is a current account surplus, we can attempt convertibility on the capital account. This process has taken at least 10 years, and often much longer, not only for the countries in Asia such as Japan, Korea and now Thailand, but also in western Europe. Most countries in western Europe moved to convertibility on trade, or on current account, in the late 1950s or early 1960s, and convertibility on capital account as late as the mid-1970s.

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Q: Should there be a dramatic surge in the country's foreign exchange reserves, do you think there is a need to re-assess the earlier decision to convert the stand-by arrangement with the IMF into an extended fund facility?

A: If there is a dramatic increase in the level of our foreign exchange reserves, and I hope there is, we would need to reassess the question of whether the stand-by arrangement with the Fund should be converted into an EFF. In such an event, the IMF will not provide finance unless the balance of payments need is established. What is more, from our point of view it would serve little purpose to enter into a medium-term arrangement if the balance of payments stabilises on a sustainable basis.

Q: Is it correct to perceive the EFF as involving a trade-off between stiffer conditionality on the one hand, and a longer loan repayment schedule on the other?

A: Yes, an EFF implies a longer period of repayment and a lower rate of interest on any enhanced structural adjustment facility (ESAF) resources that may be blended therein. But it would mean much tougher conditionalities. This is usual in IMF arrangements. The larger is a member country's borrowing, as a proportion of its quota, the higher is the conditionality.

Q: It is argued that medium-term programmes with the IMF and the World Bank erode independence in decision-making by governments. What do you think?

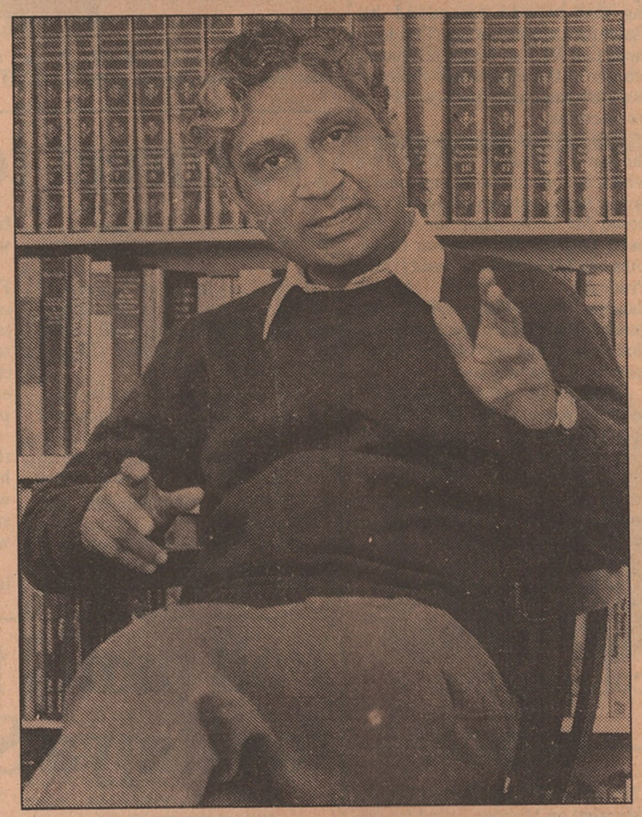
A: Critical evaluations of stabilisation and adjustment programmes in Latin America and sub-Saharan Africa, guided by the IMF and the World Bank in a medium-term perspective, point to a significant danger. There is a steady externalisation of policy formulation. This has two implications. First, responsiveness to changing and evolving situations is significantly reduced, as policy prescriptions are characterised by an analytical absolutism. Second, sensitivity to social and political realities is sharply eroded. Similar concerns are expressed by Oktay Yenal, the resident representative of the World Bank in India, in a very perceptive article about policy-based assistance to developing countries co-ordinated by the World Bank, and published in *The Economic Times* last month. "Soon, the policy engineer finds himself attempting to do nothing short of what political leaders of countries are supposed to do. This, of course, is a grave mistake...can open the door to what some have called neo-imperialism and the imposition of external governance on what has to be national policies."

Q: What are the prospects of the Indian economy in terms of stabilisation in the short-run and adjustment in the medium-term?

A: In any process of stabilisation and adjustment, there are serious problems of transition, the importance of which cannot and should not be minimised.

Q: What is the most important problem?

A: The fundamental problem of transition arises from the fact that the speeds of adjustment on the demand side and on the supply side are considerably different. Fiscal adjustment and monetary discipline can be used to squeeze aggregate demand, so that the speed of adjustment on the demand side is fast. On the other hand, the speed of adjustment on the supply side is inevitably slow, particularly in economies characterised by structural rigidities where resources are not mobile across sectors, or substitutable in uses. The fast dynamics of demand and the slow dynamics of supply have two important macro-economic implications that are crucial in the adjustment process.



First, insofar as aggregate demand is greater than aggregate supply, or the sectoral composition of demand does not match the sectoral composition of supply, and balance of payments constraints prevent excess demand from being met through imports, inflation is the logical outcome.

Second, fiscal adjustment and monetary discipline which squeeze aggregate demand in the short term may constrain supply responses in the medium term. Yet, without a foundation of macro-economic stabilisation in the short term, policy reform cannot produce the desired results in the medium-term. This is the crux of our problem. We are embarking on an adjustment process in a situation of deep macro-economic disequilibrium.

Q: Is there not a real danger of stagflation?

A: The transition path of stabilisation and adjustment is like walking a tightrope. The Achilles heel of any such programme is the rate of inflation or the balance of payments. If inflation does not slow down or the balance of payments does not stabilise, the virtuous circle is easily transformed into a vicious circle, as the exchange rate and the price level chase each other. The possibilities of stagflation are then considerable. This did happen in Latin America where the 1980s are, in retrospect, described as the lost decade. Economic stagnation, which led to rising levels of unemployment and falling per capita incomes, was juxtaposed with hyper-inflation. Many countries in eastern Europe in their process of transition, from planned systems to market economies, are experiencing similar difficulties.

Q: What is the prospect in India? Can we say anything at this stage?

A: The evidence available so far on India is limited, but there is cause for concern. There are no signs of a slow-down in the rate of inflation, which remains high by standards in India. The accumulation of foreign exchange reserves suggests that stabilisation may have begun, but one swallow does not make a summer. The reserve build-up is attributable to the draconian import compression, support from the IMF, World Bank and ADB, and the remittances received under the amnesty scheme. There is no evidence of a turnaround in export performance. The import compression has been lifted, in my view prematurely, and we could see a rapid erosion in the level of reserves. At the same time, recession appears to be setting in. The industrial sector is obviously hurt by the high interest rates and the massive credit squeeze. Firms with high debt-equity ratios and large working capital needs, particularly those in the small-scale sector, would fare the worst. This may be accentuated further by the fiscal adjustment because, in India, public investment crowds-in rather than crowds-out private investment.

Q: Are there problems on the supply side associated with structural policy reform?

A: The sequence and the speed of structural reform are a cause for concern and it may be wise to hasten slowly. The process of policy reform is sustainable only if two conditions are satisfied. First, it must be acceptable to polity and society. Second, the pace of the transition must be such that it can be absorbed by the economy. In sum, an ailing and weak patient in need of gradual convalescence may not become healthy and strong with shock therapy. For the economy, the major problems that I perceive in this context are exit and trade liberalisation.

Q: What is the problem of exit?

A: Reform in terms of industrial deregulation is seeking to remove barriers to entry and limits on growth in the size of firms. This is both necessary and desirable if it reduces the degree of monopoly in the industrial sector or enhances the degree of competition among firms. It would almost certainly, albeit with a time lag, create sickness in units that are not competitive. In the medium-term, this would create problems associated with exit, whether retrenchment or closures. However, in the absence of social safety nets, at levels of income and employment that prevail in India, it would be exceedingly difficult to remove barriers to exist and cope with the associated problems in economy and society.

Q: If the object is to expose the economy to international competition, why are you concerned about trade liberalisation?

A: We have a trade regime characterised by substantial restrictions on imports and high tariff levels, which cannot be changed in the short-term because of the acute balance of payments difficulties and the dependence of the exchequer on customs duties. After all, more than 45 per cent of the Centre's net tax revenue is from import tariffs. This means that industrial de-licensing and the liberalisation of foreign investment would move the allocation of investible resources to highly protected domestic manufacturing activities, which would in turn create monopoly profits. Suppose we abstract from the balance of payments constraint as also the fiscal crisis and envisage a significant reduction of import restrictions and tariff levels. We may, then, move from a situation of too much protection to a situation of too little protection. In all probability, the industrial sector would not be able to cope with the transition if it is so rapid.

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Q: It has been argued that the Indian macro-economic adjustment programme is under-funded, in that it will not have the level of foreign exchange reserves required to liberalise imports to the point where lower customs duty levels will be neutralised by higher import volume. Comment?

A: I agree with this view. The BoP situation is bound to be exceedingly difficult this year and the next, but the strains would continue even thereafter. Given the income distribution in our society and the associated patterns of demand, industrial deregulation, a more open trade regime and a liberal policy towards foreign investment would, perhaps, lead to a greater import intensity of domestic production which, in turn, may create a hump in the current account deficit. The limited availability of external finance may, then, force the economy into excessive deflation which reduces both aggregate demand as also the capacity of the economy to restructure on the supply side over time. Adjustment at a forced pace in a programme that is under-funded will only land the economy in serious BoP difficulties where the outcome would be default or a further accumulation of external debt.

Q: Where in your opinion does this leave the promise of adjustment with a human face?

A: Fiscal adjustment and economic reform is not simply a matter for the drawing board. In the period of transition, it imposes a burden of adjustment that is distributed in an asymmetric manner. Without correctives, the burden of adjustment is inevitably borne by the poor. Whatever we might say about social safety nets, we do not have the resources for this purpose. It cannot and will not suffice to assert that the burden of such adjustment would have to be borne by the affluent and the middle class, simply because the rich in our society have the incomes to immunise themselves from the burdens of structural adjustment.

Q: Surely, there can be no adjustment without pain?

A: I recognise that there can be no adjustment without pain, but we must do everything possible to minimise the social costs of the transition, in particular the burden on the poor. The reality, I fear, may turn out to be the opposite. Inflation would make the rich better off as it redistributes income from wages to profits and the poor worse off as it erodes their incomes which are not index-linked. The soft options in fiscal adjustment would squeeze public expenditure in social sectors, as the resources allocated for poverty alleviation, rural development, women and children, health care and education decline in real terms. This can only hurt the poor.

Restructuring on the supply side, which follows structural reform, will inevitably impose a burden on wage-labour. The phrase 'adjustment with a human face' could then become hollow and deceptive. In the words of Bertolt Brecht, "Those who have eaten their fill, speak to the hungry of the wonderful times to come."

■ (Concluded)