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A contrarian approach to kick-start Indian industry

Monetary policies do not seem to have rediscovered themselves in the last several decades with advances in behavioural economics, not even business behaviour

INDIAN INDUSTRY HAS been sluggish for a fairly long time, and all our orthodox monetary policies have not been able to make it come alive, grow and deliver employment of any great proportion. Democracy does not seem to be the villain, as much as unimaginative policies. Opportunity costs for experimenting with an alternative policy are very low now, as never before.

The key cornerstones of such a policy would be as follows:

► **No FDI/FPI or FII targets:** Just maintain the rupee within -4%/+1% of REER values. This will be pre-fixed with a one-time readjustment to correct the current overvaluation.

► **No inflation targeting:** Target industry/economic activity-specific interest rates based on supply gaps or potential. Debunk general purpose credit measures.

► **Switch from price-based** (repo and bank rate) money volumes to volumes-based price (interest rate) discovery.

► **These monetary measures** have to be

garnished with two fiscal actions—bringing petroleum under the ambit of GST (28%), and aligning all export incentives with the 'best of ASEAN' incentive package.

Let's see how these contrarian measures are better suited to kick-start industrial revival and help in the creation of employment. First, a recapture of changes in business behaviour especially with respect to the main policy tool, i.e. interest rates.

Interest on working capital should count as variable cash costs (marginal cost to economists). An increase across the board for all players would only push up the supply curve and result in inflated prices—quite contrary to the effect desired. In any case, due to advances in communication, payment systems, 'as and when needed door delivered' systems, optimisation algorithms in stock keeping, etc, businesses are working with a lot less working capital and some enterprises even on negative working capital. The ability of long-term interest rates

to influence investment decisions is fast dwindling over time. Most of the new economy is funded by equity capital and sweat equity. In conventional manufacturing, gone are the days of 4 or 3:1 debt equity structures. Credit rating agencies frown at 1.5X debt levels now. Investments in new economy areas like Google, Ola, Paytm, IPL, casinos, Reliance Jio and space travel are more an outcome of guts and vision, rather than RoI and IRR-based like automotive sector, consumer products and street corner restaurants. And the new economy's share in investments is overshadowing that of the traditional economy's. These have reduced the potency of some of the monetary tools. More savings are also finding their bypass route to investments than through conventional banks and financial institutions, i.e. through private equity, VC, HNI, PMS systems, etc. Interest can affect consumer demand and have some effect on savers conduct, and this could be used for maximum impact.

The Indian context

The general capacity utilisation in industries is stuck at less than 75%—a level that will hardly inspire any investments. A great proportion of consumption growth has been met through imports from more cost-competitive nations. A few relatively better cost-competitive players have seen their capacity utilisation grow to fuller levels.

There are some industries (such as telecom) that have seen investment, but these are largely in the nature of 'overtaking' investments, i.e. fresh investments with superior offerings, driving customers away from existing players, thus rendering already standing investments to lower capacity utilisation levels. Some such industries (such as modern retail and banking) have also destroyed jobs through the use of technology.

A contrarian approach

Working capital interest rates for manufacturers with fuller utilisation should discourage stocking. Credit flow for downstream distribution and trade for such industries may be either curtailed using physical norms or prohibitive interest rates. But long-term interest rates should be kept lower to encourage quick capacity additions. Industries which see low capacity utilisation need lower working capital and export-facilitating interest rates, but long-term loan rates should ideally dissuade fresh capacity additions.

Overtaking investments should be mandated to raise a greater proportion of funds through own or equity funds. Besides being risky themselves, they also create systemic risks for all the existing players and their financing banks, and hence the whole industry should be

charged risk premiums and far tighter debt/equity targets (<0.5 maybe), which would slow down such investments.

The above clearly indicates a need to junk the current general purpose credit policies and adoption of a sector-specific approach, with working capital and capacity addition loans being priced differently—risk premiums on one end and incentives on the other.

The 2008 meltdown could, in large measure, have been avoided by controlling just one industry—construction and mortgage-backed securitisation. Industry-focused approach produces results faster, is focused on the causes, and avoids unnecessary spillages and unintended harmful side-effects on other industries.

Sticking to the REER corridor of -4%/+1% on a yearly basis will help in competitive (to the rest of the world) inflation anchoring (of traded/tradable goods and services and thus overall), unless, of course, we import a large portion from the Venezuelas of the world. A 4% undervaluation will somewhat neutralise the loss/lack of competitiveness due to our infrastructural bottlenecks, substandard scales and bureaucratic bottlenecks. Such REER targeting will also determine levels of FPI/FII targets and portfolio investments.

Even if we want to anchor inflation, 6% makes sense, but giving the same width on the underside at 2% does not make sense. Any growing economy needs higher inflation and the corridor for an anchor of 4% may even be 4-6%, instead of 2-6%. Or even just 6% maximum, like highway speed limits.

Inflation, interest rates and volume of credit all have their influence on economic activity with varying degrees, with inflation being the least direct and perhaps most loose, and the volume of credit most direct and perhaps more immediate. Moderating through a more direct tool can be more effective. Interest rates can be the resultant, than being a determinant.

Fuel oil has the largest influence for a single item and should perhaps be under the central control of the GST Council, rather than be a matter of political Centre-state slugfest. Proper control of a few such items could moderate inflation to the desired levels. Indian incentives as well infrastructure are way too uncompetitive, and even as physical infrastructure takes time, one can work with export incentives.

Monetary policies increasingly look like wet blankets to suppress high fever. Without redressing the causes, we will only reap the harmful side-effects. Monetary policies do not seem to have rediscovered themselves in the last several decades with advances in behavioural economics, not even business behaviour.