NOTE

Inflation and Investment

Bharat Jhunjhunwala writes :

A year ago the Indian economy was flying mighty. Inflation was in control. Growth rate was in excess of ten percent. Foreign investment was pouring in torrents. Sensex had scaled an all-time high of 21k. The rupee had risen to 39-a-dollar from the low of 49. This success had global implications, however. India along with China, imported large amounts of oil to meet their increasing energy requirements. Likewise they imported steel, machinery and airplanes. This led to global increase in prices of most primary commodities like oil, steel, cement, wheat and edible oils. The global economy warmed up just as the radiator of the car cruising at 100 km per hour heats up.

Economy of the United States could not bear this heat. That economy was standing on a quicksand of debt already. The increase in price of oil and other commodities shook up the sands and that economy began to sink. American investors adopted a defensive posture and began to withdraw their investments from the Indian markets. The success of India and China contributed to this exit of foreign investors in no small measure.

The spiral of price rise was not contained by providing cheap oil, however. The rise in commodity prices was widespread. It included almost all primary commodities like coal, steel, wheat and edible oils. Just as tires, silencer and gear oil-all get heated up along with the radiator in a fast moving car; similarly prices of other commodities rose in addition to those of oil. Inflation continued to increase and crossed the 10 percent threshold despite cheap oil. It became necessary to control this price rise in order to protect the political fortunes of the ruling coalition. It was necessary to cool down the economy and contain the demand pressures to bring the prices down. Though this writer disagrees, yet it must be conceded that there was logic to this approach. The mistake made was at the second level–which source of economic growth was to be stifled?

The pressure on prices arose from high rates of investment. The additional demand for steel, cement and oil was coming from the setting up of new factories. The two sources of such investment were domestic and foreign. The price pressure could be contained either by subduing domestic- or foreign investment. Here the Government made a grave mistake. It decided to subdue domestic investment and continued to open up to foreign investment. The Government thought it could continue to obtain kudos from the foreign investors even tough domestic businesses were forced into hard times. The Government raised domestic interest rates to give effect to this policy. This led to higher cost of borrowing for domestic businesses and investment was reduced as seen in lowering of rates of economic growth from 11 - to about 8 percent. At the same time it tried to woo foreign investors by speedily approving FDI proposals and making known its intention to increase foreign investment limits in insurance and other sectors. But to no avail. Foreign investors did not bite the bait.

The Government has failed on both counts. Inflation continues to remain high despite selling oil at subsidized rates. Foreign investors continue to flee despite killing domestic businesses. Reason is that the Government is not truthful. Government wants to keep the people in the dark and obtain their votes on the sly. □