NOTE

Easy Money Policy

Bharat Jhunjhunwala writes :

The reserve Bank had initiated an easy money policy last year when the global recession had struck India. Commercial Banks are in the normal course of business required to invest a part of their money in Government Securities and another part as cash with the Reserve Bank. These are called Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) respectively. These measures are necessary for security and safety of the banking system. Both the SLR and CRR were reduced by the Reserve Bank last year. That had freed resources of the Commercial Banks for increased lending to businesses and investors. Simultaneously the Government has made substantial increases in expenditures. The salary of government employees was raised under the award of Sixth Pay Commission. Expenditures in construction of highways as well as in employment guarantee program were also increased. These two moves-easy money policy of the Reserve Bank and easy expenditure policy of the Government-put more money in the hands of the people and Inda was to maintain a respectable growth rate of 5-6 percent in these difficult times.

Last week the Reserve Bank has signaled reversal of the easy money policy. The amount required to be invested in Government securities-the SLR-has been raised from 24 to 25 percent. This will not have any effect immediately because the Commercial Banks are already holding about 27.6 percent of their money in Government Bonds. Yet this increase is important because it signals that SLR may be further increased in the coming months. Consequently the Commercial Banks will start tightening their belts and become more cautious in lending.

Finance Minister Pranab Mukher-jee has, however, indicated that the increase in government expenditures will continue as part of the stimulus package. The Government does not have the income to make these expenditures though. It is issuing bonds and borrowing from the market to raise money for this purpose. The Government will have to redeem these bonds in the coming years. If the economy has revved up by then and tax incomes of the Government are buoyant, then all is well. Additional revenues will be used to redeem the bonds. But if the economy remains placid and revenues are flat, then the Government will have to impose higher taxes to raise money for this redemption. Domestic businesses will be doubly hit in this circumstance. They will have to manage with reduced lending from the Commercial Banks and higher taxes from the Government. Most analysts estimate continuance of the present 5-6 percent growth rate for the next year. Therefore, there appears to be only a slim chance of an increase in tax revenues. Thus an increase in taxes for business is likely. There are difficult times ahead.

But the troubles of Indian economy due to the abovementioned policies of Reserve Bank and the Government may be partly compensated by the inflow of foreign capital. Global capital will come to India despite these negative policies only because other countries will be in much worse position.

The Reserve Bank is adopting a tight money policy as it is concerned about inflation. The increase in government expenditures is likely to push inflation upwards.

The increase in government expenditures can be beneficial if it is of good quality. Say, for example, the government allows money from the market to invest in factories of Cement Corporation of India. That leads to increased production of cement in the country and prices will be controlled. The profits earned by Cement Corporation would be used to repay the Bonds that were issued. Or the expenditures are made in education. Earning capacity of the students will be increased. They will pay more taxes which could be used by the Government to redeem the bonds. The same government expenditures will be harmful if the money is leaked away. Say, the money raised by the government by issuing bonds is siphoned away by the Ministers and sent abroad to be deposited in Swiss Banks. Then the Government will not obtain additional incomes from such investment and additional taxes will have to be imposed on the domestic businesses to raise money for the redemption of Bonds. This policy will be a loss proposition for the country. □□□