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A Common Economic Recipe for India and Pakistan

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Abstract

Both India and Pakistan are passing through delicate political times. India is getting ready to hold the next general election no later than the spring of next year when the term of the current government expires. Pakistan, having held elections in May 2013, has a new government in place. In both cases the government will be tested in the field of economics. How the performance of the two governments will be judged is a question that is being debated in the two countries. The Indian Government under Prime Minister Manmohan Singh has chosen to allow its performance to be determined essentially by the prices that people have to pay for the items of everyday consumption. Inflation has been relatively high in recent months. The new Pakistani Government, headed by Prime Minister Nawaz Sharif, seems half-inclined to treat the level of prices as an important test for his ability to restore economic health to the country. In adopting these policy decisions, the two governments are making serious political mistakes. Their electoral appeal will be determined by the rates of growth of their national economies and not by the modest changes in the level of prices.

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Fluctuating Currency Values

For the last several months the South Asian currencies have been under a great deal of stress. The Indian rupee has lost 20 per cent of its value in terms of the American dollar since the beginning of the year. The Pakistani rupee lost close to 14 per cent of its value in the same period. Both governments have taken some steps to steady their currencies. Both have had some success. In both cases the rupee has pulled back from the lows it reached. But in focusing on the value of their respective currencies they have made one big mistake that will prove to be politically costly. They have opted for stabilisation over growth. For this they have been punished by the markets. The markets will continue to be sceptical for as long as the policy makers don't change the long-term course they are taking.

It is recognised even by those who focus on their occasional failures that markets are good at a number of things. They can sense when the making of public policy is being done in a state of panic. That is what happened in India when the Indian rupee plunged in value with respect to the American dollar. That was in mid-August. At one point it took seventy Indian rupees to purchase one American dollar. In pushing the value of the rupee down, the markets were responding to a series of ill-advised moves by the country's economic managers. The most troubling of these was the focus on reducing the level of inflation even if it meant hampering growth. This was done by using such monetary instruments as the rate of interest controlled by the Reserve Bank of India. The central bank took other steps as well. It provided foreign exchange to the oil-importing companies so that their presence in the market did not create a US-dollar liquidity problem. These were essentially short-term measures with a short-term outcome – the partial recovery in the value of the rupee. It will take an entirely different strategy to put the rupee on a firmer ground.

Gold 'Flow' Across Pak-India Divide

Even though the economies of India and Pakistan are not connected in any meaningful sense, they share a long and somewhat porous border which means that in some cases when shortages build up in one country, supplies flow in from the other. This has happened in the case of gold. India, in order to save its reserves from being depleted, sought to control the demand for the metal, imposing a heavy duty on its import. This created a sharp price differential across the border which resulted in gold imports rocketing in Pakistan. The additional supplies were brought in essentially to satisfy the large Indian demand for the precious metal.

The plunge-and-recovery by the Pakistani rupee was equally spectacular. While the quick fall and some recovery of the Indian rupee happened over a period of two weeks, the Pakistani rupee moved down and up in just two days, on 26 and 27 September. After the rupee traded at more than 110 to the American dollar, the State Bank of Pakistan stepped in and pumped US$ 50 billion to US$ 60 billion into the money market. With dollar liquidity thus restored,

the rupee recovered and the week closed with the exchange rate at a little over 106 to a US dollar. By flooding the market with American dollars the authorities have bought a little bit of time. They are also attempting to open a line of credit with a consortium of banks to have more foreign exchange at hand if the pressure on the rupee does not ease.

The Pakistani markets are testing the resolve and competence of the new policy makers who have been in place for about four months. Will they pull back some of the measures that were incorporated in the budget presented in early June. Some of these have produced jitters among the relatively well-to-do segments of the society. These have perfected the "tax-dodge" – the ability to avoid the taxman by playing games with the system. The most cited reason for the market's nervousness was the permission given to tax authorities to access the bank accounts of high net-worth individuals. The people holding large accounts reacted by withdrawing them from their banks, converting them into US dollars, and sending a good part of the acquired amounts overseas. This resulted in a sharp build-up in demand for the American dollar which in turn increased its price in terms of rupees. The result was a five per cent plunge in the value of the rupee, the sharpest one-day fall in the country's history.

Restoring Market Confidence

The only way to steady the markets on both sides of the border is to give a clear signal to them that the policymakers have well-thought-out strategies in place to address the longer-term issues the two countries face. Here India has greater degrees of freedom than those available to Pakistan. To some extent the policy makers in Islamabad have their hands tied because of the programme they have signed with the International Monetary Fund. The choice they have to make is between growth and stability. Even though the IMF's traditional focus on the latter at the expense of the former has been softened somewhat by its experience in the late-1990s during the Asian Financial Crisis, the institution has not significantly departed from its long-held philosophy. Then the countries receiving help from the institution had to drastically reduce public expenditure; curtail domestic demand by raising interest rates; and open the economies to foreign trade. The strategy worked but at the expense of a sharp economic contraction, loss of jobs and increase in the incidence of poverty.

The approaches being followed by both India and Pakistan are less drastic but both countries are leaning towards achieving economic stability even if it means reducing the rate of growth. Both are using the interest rate as the instrument for stabilising the economy. The policy makers fear inflation more than a slowdown in the rate of economic growth but they don't have the political muscle to rein in government expenditure. Not being able to use fiscal policy as a stabiliser, the policy makers are using monetary tools. That is a mistake. They should take some risk with inflation to get growth back on track. That approach will also create greater confidence in the markets and help with the exchange rate.

Importance of Economic Growth

Growth versus price stabilisation is not a new debate. Nor is the debate about the most effective instrument for increasing the rate of economic growth. Liberal economists have always put growth above stabilisation. It is only with growth that the poorer segments of the population can be helped. There is a virtual consensus among policy analysts that interest rates are the most important tool available to governments for promoting growth. Economists use a formulation called the IS curve (the Investment-Savings equation) to show how interest rates can slow or increase the rate of economic growth. For economies such as those in South Asia, slight interest adjustments can produce telling results. With sharp declines in GDP growth in India over the last year and a half, the country needs to lower interests to reignite growth. With Pakistan's economy stuck in a recession for the last six years, it is also the lowering of the interest rate that should be the policy of choice. In both cases, however, the currency markets have pushed the policy makers in the opposite direction. Sharp declines in the values of the two currencies have persuaded the economic managers in the two countries to raise interest rates. By doing so they have stabilised – perhaps only momentarily – their currencies but they have achieved that result by jeopardising growth.

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