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Improving India's infrastructure

With forex reserves of about US\$140b, India is considering using part of its war chest to upgrade its public facilities

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IN their quest to raise the yields on their large stockpile of foreign exchange reserve holdings, many Asian countries have been actively exploring the possibility of using some portion of their reserves to augment their physical infrastructure.

The debate on this issue is most advanced in India which currently owns over US\$140 billion reserves as of mid-April - the sixth highest in the world. While the country is on a sustained path of fast growth (averaging 6-7 per cent annually over the last decade), substandard infrastructure remains a significant constraint to India in its pursuit to scale up its labour intensive manufacturing activities and to boost its tourism sector which has so far failed to live up to its enormous potential.

India currently spends only about 6 per cent of GDP on infrastructure compared to 20 per cent of GDP in China (although China is probably over-spending). India's Prime Minister Manmohan Singh recently placed the country's infrastructure needs at a hefty US\$150 billion over the next decade. So there is clearly a need for the country to jumpstart spending in this area. It is in this light that the highly regarded Deputy Chairman of India's Planning Commission, Montek Singh Ahluwalia (who is a former Finance Secretary), proposed to channel about US\$5 billion of India's international reserves annually (about the same amount of inward FDI that India attracts each year) over the next few years towards financing infrastructure projects.

Having heard the growing calls to find innovative means of closing India's gaping infrastructure deficit, in the 2005-2006 budget, Indian Finance Minister P Chidambaram announced the creation of a 'Special Purpose Vehicle' (SPV) for 'financially viable' infrastructure projects that have difficulty in raising private resources.

The financial SPV, which will be under the Finance Ministry but distinct from the fiscal budget, will be allowed to raise long-term funds from the domestic market as well as international capital markets. It is expected that bonds will be foreign currency denominated with sovereign-like characteristics: the Indian government will provide at least a partial guarantee, thus reducing the credit risk. This in turn should help keep the cost of borrowing by the SPV fairly low. The SPV will also be partly funded from some of the country's stockpile of foreign exchange reserves, though the quantum of funding from this war chest has not yet been revealed.

The SPV will in turn offer long-term loans for selected projects in key areas, namely

roads, ports, airports and the tourism sector generally to supplement other loans from banks and financial institutions. The lending limit by the SPV has been set at 100 billion rupees (roughly S\$3.8 billion) for FY 2005/06, and is to be fixed at the beginning of every financial year.

An additional provision of 15 billion rupees has been set aside from the government's budget to act as a 'viability gap' fund. This long-tenure and low cost funding source is meant to fill the shortfalls in the capital funding required to make projects viable and attractive for private investments. While this proposal is rather novel, there are a number of areas of concern regarding the plan to fund infrastructure using the SPV vehicle.

'Hidden' deficit

One, the central government will counter-guarantee the SPV's borrowings. This effectively raises the government's contingent or off-budget liabilities. This 'hidden' deficit is one of the main reasons why fiscal authorities in India and elsewhere generally seem to prefer using the indirect means of capital expenditure financing (via a SPV) rather than selling bonds directly to the central bank in return for reserves. However, while the SPV scheme is a clever accounting device, the economic consequences are identical to running an actual fiscal deficit.

India needs to be especially concerned about the size and consequences of its overall fiscal deficit which currently stands at an uncomfortably high 9.5 per cent of GDP (this excludes contingent liabilities). Fiscal consolidation is urgently needed, failing which future growth may be derailed.

Two, there remains the nagging issue as to whether the SPV scheme will make much of a difference to India's infrastructure development. As noted, the government proposes to focus on 'financially viable' projects. The implicit assumption here is that there are potentially solvent projects that are not moving forward because of a dearth of private investments. Is this a reasonable assumption?

Many infrastructure projects in developing countries like India may not be viewed as being financially viable to private investors because of perverse/non-economic pricing policies, ineffective delivery systems, uncertain regulatory frameworks, and a slow moving bureaucracy which hinders quick decision-making. Indeed, it may well be that these pose far greater impediments to India's infrastructure development than just the quantum of financing, and as long as they remain unresolved, it is not clear as to how effective the SPV scheme will be in filling critical gaps in infrastructure.

Three, while potential projects to be financed are to be appraised by an inter-institutional group of banks and financial institutions along with members of the Planning Commission, there are also valid concerns as to whether the funds available to the SPV will be appropriately channeled. Will appraisals of projects be based on solely economic (rather than populist) considerations, and if so, how effectively will they be monitored (in view of the long-term characteristics of such funding and possible short-term tenures of

members of the inter-institutional group)?

Four, there is the question of who bears the risk of unhedged external borrowing by the SPV. Presumably the government will offer guarantees for exchange rate risks, and thus compensate the SPV in the event of depreciations of the rupee (although this might not happen). Because of such concerns, it has been suggested that a relatively greater share of funding for the SPV be drawn from available forex reserves rather than external borrowing which will raise the country's overall indebtedness. As is often noted, it is like household's leaving savings in low interest earning accounts while simultaneously borrowing at high interest rates to finance their expenditures. Why not just use the idle savings for the planned expenditures?

There are also some specific concerns about channelling reserves to fund infrastructure. India's central bank, the Reserve Bank of India (RBI), has rightly been wary of the potentially inflationary consequences, as the proposal effectively implies that additional liquidity will be released into the economy. Of course, to the extent that the improvements in infrastructure needs raise the supply capacity of the country, the inflationary consequences due to excess liquidity may only be short-lived.

However, the interim period can last for quite some time given the long gestation lag of infrastructure projects. As is often noted, inflation is like toothpaste, 'easy to squeeze out but extremely difficult to push back in'. In view of this, it is completely understandable why there should be concerns about the inflationary effects of such a policy.

One seemingly ingenious method of limiting of potential inflationary consequences is to require that most of the intermediate inputs needed for local infrastructure projects (steel, cement, machinery, technology etc) be imported. The logic is that imports do not add to domestic demand and can thus temper the immediate inflationary pressures. The rise in imports will also reduce the size of the country's balance of payments surplus, hence moderating the pace of future reserve buildup. While there is economic merit to this argument, it has two important limitations.

First, it is not clear exactly how import-intensive infrastructure development really is. Most of these projects have a high local or non-tradable component (labour and transport). Thus, there is clearly a limit beyond which the inflationary impact can be offset. Therefore, these expenditures cannot possibly be entirely inflation-neutral.

Second, even if the infrastructure projects are import-intensive, the fact that the country is importing intermediate goods at an undervalued exchange rate implies that it is relatively more costly for the country (compared to if the country maintained and imported at a fairly valued exchange rate).

Hard to justify

In effect, therefore, the country is choosing to pay more for its capital equipment and resource needs while simultaneously subsidising its exporters. Such a policy is hard to

justify on economic terms unless it can be argued that exports offer significant positive spin-offs to the rest of the society. In any event, this is just not a cost-effective means of funding infrastructure.

One way to counteract the adverse macroeconomic consequences of maintaining an undervalued currency and the additional liquidity from the release of reserves (given that the process will almost certainly not be inflation-neutral) is to concurrently reduce import tariffs. Indeed, India has continued to lower customs duties as it attempts to align its tariff structure to its East Asian neighbours and trading partners.

While bringing down protection levels should be welcomed as a means of enhancing competition and increasing economic welfare in and of itself, it may compromise the country's budgetary position. Also, the available reserves cannot, and should not, be viewed as a pot of gold that can soften the budget constraint.

There are reasons to be skeptical about aspects of the SPV proposal and the use of forex reserves to help fund infrastructure. But the good news is that Indian policy makers and business leaders have recognised the growth-hindering effects of India's comparatively poor quality physical infrastructure and are looking to tackle this issue with some urgency.

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