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Crash-landing the Indian Economy

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Ill-conceived and poorly implemented policies have stalled the growth engines of the Indian economy. One such decision was November 8, 2016, demonetisation of high value currency notes. The file photo is of a bank in Delhi that had run of of cash on December 1, 2016. AP

Dark clouds loom over the economy but, paradoxically, this is a result not of any policy paralysis but of hastily thought-out and implemented policy decisions, such as demonetisation, whose full consequences are still unfolding, and GST, whose roll out has been hampered by a complicated and sub-optimal design. The situation has been compounded by the refusal of an increasingly populist Narendra Modi Government to heed its own advisors, including the Chief Economic Advisor, Arvind Subramanian, who has consistently and diligently been raising red flags over areas of concern. The economy can recover and return to the high-growth path with bold reforms but the policy response so far has been feeble and missing urgency, writes senior economic journalist ***Puja Mehra****.*

India's economy is slowing. The pace of Gross Domestic Product (GDP) growth has lost momentum in each quarter since the one ending March 2016. With every passing quarter, the slowdown is explained away as either a transitory phenomenon or for reasons beyond the government's control—deficient rains, the sluggish world economy, high interest rates or lately due to demonetisation and the Goods and Service Tax (GST). The reasons offered have changed. The economic trend has not.

In the boom years during the tenure of the United Progressive Alliance's (UPA), four engines powered the economy: exports, government investments, private consumption and private investments [1] . Of these, two were still running at the time the Bharatiya Janata Party-led National Democratic Alliance (NDA) took office: government investments and private consumption. The other two, exports and private investments were already sputtering with no uptick following regime change. This is well known. Official statisitcs have captured the weakness consistently and unambiguously—in exports for the past three years, and in private investments for more than five years. Yet, the debilitating impact of this on growth has received inadequate policy attention. The pain has begun to spread consequently to the rest of the economy: Private consumption and government investments growth rates started slowing in the quarter ending June 2017 [2] . The economy's four growth engines are stalling or slacking; none is picking up speed.

Private consumption and government investments depend on how well the economy is doing. As incomes improve, private spending and tax collections pick up. Let's look at exports and investments. The global economic downturn that followed the financial crisis of 2008 dealt exports a body blow. Before that, exports were growing smartly. When the global economy recovered, it lifted the exports scene in most Asian countries, but Indian exports are stagnating, their competitiveness eroded by the over-valued rupee [3] .

India's economic future can improve significantly with investments-led growth. The share of investments, the principle growth engine in the economy, in the GDP has declined steadily over the past five years. The decline in private investments is so sharp, it has offset the increases in government investments. The NDA government even deferred its fiscal deficit targets to create space for stepping up investments, but the investments slowdown is nonetheless deepening. The steps taken for improving the ease of doing business and the foreign investments regime have proved insufficient to restart the private investments cycle. As a result, new jobs are not getting created which means consumption can only grow up to a point.

Why are investments on hold? The returns-risk projections of projects are not favourable. Companies are not convinced new factories will be sufficiently profitable. Among the variables that affect investment decisions are costs and availability of finance, land, labour, technology, logistics and taxation. Market prices, or in other words, consumer prices inflation is a determinant of profitability on the revenue side. The government is politically sensitive. So, it has set a low target for consumer price inflation. For the same reason, it is unable to progress on land and labour reforms. The flow of credit in the economy has thinned to a trickle even as the government is moving on bad bank loans belatedly and inefficaciously. Several wilful defaulters are absconding. More than a fifth of large companies did not earn enough this year to be able pay interest on their loans [4] . Naturally, the pace of new loans is the lowest in more than six decades. Even if big companies can raise finance from alternative sources, the smaller ones cannot. Most of the other factors have escaped policy attention altogether. Additionally, in an environment of constant shocks and unanticipated policy changes, investment decisions tend to get postponed. If people feel unsettled, they are unlikely to invest.

The Reserve Bank of India (RBI) advised against going ahead with demonetisation, explaining how the destructive potential would far outweigh any benefits, even listing alternative policy tools more likely to yield positive results5. This too, the government overruled. In fact, it has tended to view all feedback as adversarial.

The government's Chief Economic Advisor Arvind Subramanian has consistently and diligently been raising red flags over the damage to the economy: from bad bank loans, the investments slowdown, the distorted signals to farmers on what to grow and how much to the sub-optimal design of the GST and the never-ending delays in the reforms of land, labour and the public sector. There seems to be inadequate regard for sound economics and trained economists. The government is inert even to the advice of its own economists; the analyses documented in successive editions of its own publication, the Economic Survey, have influenced policy minimally. The government paid no heed to the warnings, the price for which is being paid by the economy today. The Reserve Bank of India (RBI) advised against going ahead with demonetisation, explaining how the destructive potential would far outweigh any benefits, even listing alternative policy tools more likely to yield positive results5. This too, the government overruled. In fact, it has tended to view all feedback as adversarial.

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At the commemoration function of the 80th year of the RBI, Prime Minister Narendra Modi had confessed to being an economics novice [6] . If a Prime Minister says he doesn't know economics, and, at the same time, refuses to listen to those who do know, economic policy-making is bound to suffer. Mr. Modi has dispensed with the Economic Advisory Council to the Prime Minister, an institution that served his predecessors. A distinguished economist himself, former Prime Minister Manmohan Singh, relied for inputs on the council. Some of India's best-known economists were on it, handpicked by Dr. Singh. The advice Dr. Singh received could arguably have been assigned greater weightage in policy formulation than was the case. Even so, the point is that the collective wisdom of the domain experts was available and informed the internal debates in government. As it turns out, the pick-up in growth during Dr. Singh's tenure is the most successful anti-poverty programme on record. The number of people that exited poverty in that period is the maximum in post-1947 India [7] . The number of manufacturing jobs added in this period is also the highest ever [8] .

These empirical findings, which offer significant learnings for the NDA government, ought to have helped it focus on the revival of the economy and creation of jobs on the back of faster growth. During his prime ministerial campaign in the run up to the 2014 Lok Sabha elections, Modi had correctly identified joblessness as the single biggest worry in the economy. The anxiety over unemployment had stemmed from the jobs lost after the global economic downturn hit growth. After his government was sworn in, Modi identified manufacturing as a growth engine with renewed focus on the jobs-creating sector. The diagnosis was accurate but the government failed to back it up with an effective strategy. In 2006, the UPA government had put out a national agenda for manufacturing, projecting 2006-15 as the 'decade of manufacturing in India. [9] ' The five-year period of 2005-06 to 2009-10 was one of smart growth for the sector, before the global economic downturn brought it to a halt. If, despite Modi's 'Make In India' push, manufacturing continues to languish, one of the main reasons is the poor health of banks and indebted companies. The resolution of bad loans that were haemorrhaging both the banks and companies, spoiling their balance sheets, was a perquisite for the flagship umbrella scheme to make a difference.

Dark clouds loom over the economy. These could lift; The situation is not irreversible or irretrievable. The economy can be returned to the high-growth path. But the policy response so far has been feeble and missing urgency. There is no policy paralysis. On the contrary, decision-making is speedy. But it is of poor quality. The ill-informed idea of demonetisation and the half-baked GST roll out demonstrate the growing disconnect between policy tools and objectives. As can be seen from the provisional official statistics, demonetisation was a drag on an already slowing economy, and this when the the full impact is still to be estimated (**reference 1**). The damage to the (more vulnerable) informal economy is being measured, and will be plugged to the GDP estimates. On revision, GDP growth over the past may turn out to be even slower. The complicated design of the GST may have added to the vulnerabilities.

Over time, the measures will prove beneficial, the government insists. There is inexplicable reluctance to take decisions that will deliver speedier positive results and reverse the investments slowdown and exports stagnation. Difficult structural reforms have simply fallen off the agenda due to political calculations, among them : liberalising land, labour and agriculture. Well past the three-year point of its tenure, the government may find it even tougher now to take these up. These reforms, though painful in the short run, are necessary to change lives still mostly untouched by the reforms initiated in 1991. Unshackling these segments will nudge the economy towards its full potential and development.

The Indian political system learnt one lasting lesson the from the 1991 crisis— which is that macroeconomic stability must not be neglected. The shock of the 1990 Gulf war had turned the deteriorating balance of payments into a full-blown crisis, leaving the country's reserves with just enough foreign exchange to cover the import bill for barely three weeks, and India on the verge of a default on its external loan repayment obligations. The NDA government has so far been careful to not lose control over its purse strings, a mistake the UPA government had made, when, to stave off the impact of the global downturn, it injected fiscal stimulus into the economy. The stimulant delayed the crisis, not avert it [10] . By 2013, the pump priming, along with developments such as skyrocketing international crude prices resulted in a severe slowdown with raging inflation and a balance of payments crisis. Within months, the UPA government realised the gravity of its mistake. Through corrective action, it brought the situation under control, and steered the economy back to recovery. Growth had picked up once again and macroeconomic indicators had stabilised by the time the NDA government was sworn in. Falling international crude and commodity prices—even as China cooled down its overheated economy—facilitated the revival. The boost to growth from falling crude prices have since played out. The growth impulses started dampening in 2016 in the absence of the resolution to the debt problems. The economy has slipped off the recovery path with the slowdown in the pace of growth, and will have to be brought back on course.

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So, it is all the more important now that the government should not fall to the temptation of spending its way out of the slowdown, with one eye on the 2019 general elections. The government will have to guard against calls for going populist. The economy is growing a lot slower now than it did when the 2008 global downturn hit us. What's more, the shift to a new tax system, the GST, has made the revenue position for the year unpredictable. This calls for a conservative approach and consciously avoiding the kind of mistakes that the UPA did which in today's already adverse circumstances would hurt the economy even more. The government must do nothing now that will widen the fiscal deficit. The last thing the economy needs at this stage is the sovereign rating being put at risk of a downgrade. More so, when a new source of tension may be brewing on the country's external account: [11] The current account deficit ballooned to a four-year high in the quarter ending June, with much of the damage coming from a (possibly one-time) spurt in gold imports ahead of the GST roll out; the tax incidence in the new regime on the precious metal is higher. The episode is also a reminder that with the appreciated rupee having possibly incentivised imports, there is a greater need for vigilance on the balance of payments. Without macroeconomic stability, economic revival will be impossible.

Even if the right policy decisions begin to be taken, the return to the path of recovery may not be quick or easy. The dominant impression in the government is that lowering of interest rates by the RBI will somehow magically regenerate the growth impulses in the economy. As long a it holds on to this complacent misimpression, the outlook for the economy cannot improve. Getting realistic about the state of the economy will have to be the first step in the government's course correction.

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