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HOW TO GET THE ECONOMY OUT OF THE TWIN TRAPS

Relevant for: Indian Economy | Topic: Issues relating to Planning & Economic Reforms

The demand for additional fiscal space has to be negotiated carefully with stakeholders

India’s economic troubles appear to come in pairs. The twin deficit problem of stretched corporate balance sheets and a large fiscal gap has been replaced by twin “traps". The first of these is a classic liquidity trap, where infusions of liquidity or rate cuts by central banks seem to have little impact on the real economy. The second is a fiscal trap, in which sluggish growth in tax and other receipts makes expansionary government spending impossible without endangering fiscal deficit targets.

However, the fact that the economy resolutely refuses to respond to monetary mollycoddling does not mean that the Reserve Bank of India (RBI) can stop cutting rates or maintaining a liquidity surplus. Central banks are known to soldier on even if their efforts seem futile in the short-term. A monetary authority must appear to “care" about a slowdown and be seen to be doing their best to fight it. With real gross domestic product (GDP) growth printing at a dismal 4.5% for the second quarter of fiscal 2019-20 and nominal GDP growing at an alarming 6.1%, coupled with the fact that virtually every high-frequency indicator points to continued sluggishness, the RBI has no option but to cut the policy rate again. One could argue that the intensity of the slowdown warrants a grand gesture—a cut in the policy rate by a half percentage point.

A couple of features of interest rate behaviour need to be highlighted in understanding why the RBI’s easy money policy has failed to make much of a dent. First, the transmission of the policy rate to the lending rates has been muted. The average marginal cost of funds-based lending rate (MCLR) has fallen by just 40 basis points (bps) since January this year despite a 135 bps reduction in the repo rate. Second, the wedge between the borrowing costs of good and bad borrowers has widened sharply. The difference in the yields on commercial papers issued (for short-term working capital needs) by the least and most “risky" (the bulk are non-banking financial companies, or NBFCs) companies stands at a whopping eight and a half percentage points.

Both these features highlight the central problem that is affecting the financial system and the real economy—that of acute risk-aversion. The lingering suspicion regarding the health of NBFC balance sheets, concerns about co-operative banks and the niggling fear that there are skeletons yet to be found in some corporate cupboards have pushed up risk premiums.

The real challenge for the RBI and the government is to wring this risk out of the system. This is easier said than done. Unconventional measures such as a bad bank for impaired loans of harried NBFCs, or a move by the RBI to purchase their illiquid assets, might well be the only tricks left in the bag.

To ensure better transmission, the RBI could broaden its current mandate to link lending rates (currently restricted to only a few loan categories) to market benchmarks. However, too much regulatory control over the price of credit goes against the spirit of creating flexibility and freedom that has been central to the reforms agenda for the financial sector. The RBI needs to watch its step.

How does the economy get out of the twin traps? Old-fashioned textbooks would argue for a hefty fiscal push supported by monetary expansion to prevent interest rates being pulled up by a large budget deficit. That might well be the only way to “un-trap". However, the demand for additional fiscal space has to be negotiated carefully with stakeholders. A breach of the fiscal deficit target should not be viewed as a reckless spending binge funded by a pliant monetary authority. Else, we could see a move down the sovereign rating ladder and capital flight.

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