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# THE POLICY WAY OUT

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

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It is by now clear that India is in the middle of a sharp growth slowdown. The debate surrounding the slowdown is whether it is a cyclical downturn or a structural correction. Diagnosing the problem is key for devising policy responses. Cyclical slowdowns can be dealt with using temporary fiscal and monetary stimulus. Structural problems, on the other hand, require long-run policy responses.

There are a few clues that point to the slowdown being structural rather than cyclical. For one, most of the growth between 2014 and 2017 was sparked by a sharp increase in government spending. Given India's oil imports, the decline in the world price of oil by almost USD 50 a barrel between 2014 and 2016 represented a windfall revenue gain of USD 75 billion annually, or 3 per cent of GDP. Since the fiscal deficit barely moved, the government effectively used the windfall to finance various government schemes. Now that oil prices have reverted towards their previous levels, maintaining a stable fiscal deficit has necessitated a reduction in government expenditures.

The above suggests that absent the oil windfall, Indian growth over this period would have been 2-3 percentage points lower annually. Put differently, the economic slowdown has been ongoing for almost four years now. Cyclical downturns last a few quarters, maybe a year. Negative growth pressures for four years indicate structural problems.

A second clue that the problems are structural can be gleaned from the behaviour of investment demand. Throughout the period 2016-2018, a number of commentators and industry representatives kept up a drumbeat of criticism of the Monetary Policy Committee's refusal to cut rates. The argument was that high real interest rates, along with the restrictions imposed by the Reserve Bank of India on banks' lending in order to deal with the NPA problem, were jointly responsible for low investment demand. Since the beginning of 2019, both the monetary policy stance as well as the Prompt Corrective Action (PCA) norms have been relaxed by the RBI under a much more pliable RBI leadership. However, investment demand has barely moved in response.

The good news is that dealing with structural problems doesn't require fiscal spending. Instead, it involves non-pecuniary costs. The government has to expend some of its considerable political capital in order to usher in long-term labour and land reforms. These aren't easy because the state governments have to be roped in to get these reforms going.

The move to lower the corporate tax rate is a good one. It has the characteristic of a capital market structural reform as long as it is not used as a temporary fiscal measure. The government needs to signal unambiguously to markets that this is a permanent reduction of the base rate. Else, the uncertainty surrounding the longevity of the tax cut will undo a lot of its potential upside.

The financial infrastructure within which the economy operates is another key structural

bottleneck that needs to be addressed urgently. At the centre of this problem is the public sector banking network which accounts for 75 per cent of India's banking assets. Public sector banks introduce two complications to the financial system. First, they allow for capture of the credit allocation system by non-market forces. Second, since the regulator of banks is the RBI which is itself owned by the government, this amounts to the regulator regulating the entity that it itself is reporting to! This system is subject to regulatory capture. The government can induce regulatory changes by just changing the personnel it appoints to the upper management of the RBI or to its board, a scenario that played out in gory detail over the last year.

India needs to urgently begin reducing the importance of public sector banks in the economy. This can be done either through privatisation of existing public sector banks or through the granting of banking licenses to private operators. Given that the on-tap banking licenses on offer have attracted little interest so far suggests that the privatisation of public sector banks needs to be prioritised.

One of the few transformative ideas that was put forth in the July budget was issuing sovereign bonds. Unfortunately, it appears to have run into headwinds. The idea needs to be pursued for multiple reasons. First, sovereign bonds would force government debt to be priced in a more competitive setting. Currently, it is priced in a sheltered domestic bond market. Second, issuing sovereign bonds will force greater clarity and transparency of macroeconomic data since international creditors will demand that. Lastly, things like failure to achieve policy targets or reticence in releasing data will attract rapid punishment by markets. This fear will provide greater discipline to policymaking.

The government would also do well to revisit the appointments process to key technical and regulatory bodies. Functions like monetary policy, banking supervision, data collection and dissemination, audit of government financial accounts, are all technical jobs. Moreover, they need to be independent of government direction. It is crucial that technically competent people manage the institutions that oversee these functions. Appointing career bureaucrats with little to no domain training or background to run them doesn't help in either facilitating functional competence or in signaling the independence of these institutions from government control. Domain competence needs to be prioritised.

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