Narendra Modi govt’s growth challenge

The Narendra Modi government is facing fresh challenges on the economic front. The pace of economic growth has slowed considerably, with no clear sign of a sharp pullback in the near term. Gross domestic product (GDP) expanded at a modest pace of 5.7% in the first quarter of the current fiscal. Gross value-added (GVA) growth—the preferred indicator of economic activity—came in at 5.6%, compared with 7.6% in the same quarter last year. The slowdown has surprised analysts and most private sector economists have revised downwards their full-year forecast. It now seems difficult for the economy to get close to the Reserve Bank of India’s (RBI’s) GVA growth forecast of 7.3% for the current year. Gross fixed capital formation has slipped below 30% of GDP.

Slower growth during the quarter is being attributed to the lingering impact of demonetisation and destocking of inventory before the implementation of the goods and services tax (GST). The manufacturing sector expanded by 1.2%, compared with a growth of 10.7% in the same quarter last year. However, it is also likely that the softening of economic activity, which started before demonetisation, is still continuing. Therefore, it will not be possible, at least in the near term, to gauge precisely which factor is affecting growth to what extent. This makes forecasting the future course more difficult.

What should worry policymakers is that the economy is slowing at a time when global markets are reasonably stable and commodity prices are within India’s comfort zone.

So what can the government do to accelerate growth? There are no easy answers and the present economic situation poses a big policy challenge. Some commentators have suggested that the government should give a fiscal stimulus to revive growth. It is likely that a sufficiently large fiscal push will help growth in the short run, but there are at least three big problems with this idea. First, fiscal intervention has costs and there is no guarantee that it will take the economy to a higher growth trajectory in a sustainable manner. The government has increased capital expenditure over the last few years, but it has not resulted in crowding in of private investment. Second, the government doesn’t have the fiscal space to give a meaningful stimulus at this stage. It is important to note that state government finances have worsened in recent years and have limited the benefit of consolidation by the Centre. The general government deficit continues to remain on the higher side. Third, breaching the fiscal deficit target yet another time will affect policy credibility and could pose a threat to hard-won macroeconomic stability. Fiscal stimulus, therefore, is best avoided.

Some economists have also suggested that the RBI should intervene in the foreign exchange market more effectively, as overvaluation of the rupee is hurting exports. Although this may not provide an immediate push to economic activity and can have other macroeconomic implications, policymakers would do well to re-evaluate the exchange rate management strategy. As we have argued earlier in these pages, India needs to reassess the kind of foreign flows it wants.

Further, the need for recapitalization of public sector banks cannot be overemphasized. It is highly unlikely that a predominantly bank-financed economy will grow as desired when about three-quarters of the banking system is in deep stress. While the bankruptcy process will help deal with non-performing assets, the government needs to move fast on bank recapitalization. Private investment is likely to remain depressed till the twin balance sheet problem is resolved. The government should take advantage of buoyancy in the stock market to accelerate the disinvestment process and use the proceeds to capitalize banks and push capital spending. The initial signs indicate that revenue from GST will actually be better than estimates. This could be a big relief and can help boost public spending. Ideally, the government should pass on the benefits

of higher tax collection by reducing rates, but in the present situation it could perhaps wait for some time and use higher revenue to fund banks and infrastructure projects.

To be sure, the government has taken several steps in the right direction—such as the implementation of GST—which will help the economy in the medium to long run, but there has been virtually no movement on reforms in areas like land and the labour market. The government should go all out and use its political capital to push reforms in these sectors, which will improve the ease of doing business. All this may not lift growth in the next quarter, but will help strengthen the foundation for a sustainable economic recovery.

What should the government do to revive economic growth? Tell us at views@livemint.com

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