India’s economy: dark clouds and silver linings

The recent headlines on the Indian economy have been stark. Economic growth has declined for six quarters in a row. Inflation has more than doubled in the three months since June. The current account deficit in the first quarter of the current fiscal year was at its highest level in four years as a proportion of gross domestic product (GDP). Is it time to hit the panic button?

Some of the worries are overdone. Inflation was expected to jump back from an absurdly low level in June. The current account deficit is still being comfortably financed by strong capital flows, though the dominance of debt investments as well as the spurt in electronics and gold imports deserve closer examination. And at least some of the sharp decline in economic growth in the three months to June can be explained by inventory destocking by companies ahead of the launch of the goods and services tax (GST), so a cyclical bounce back is quite likely over the next two quarters.

Yet, there is no doubt that the Narendra Modi government faces its biggest economic challenge as it enters the final stretch of its tenure. It got an unexpected bonanza early on thanks to the collapse of global crude oil prices. It was a positive in terms of trade shock that acted as a growth driver. The sharp decline in the current account deficit added at least an extra percentage point to economic growth.

The government prudently used the oil bonanza to strengthen its finances rather than immediately pass the benefits of lower global prices on to consumers. Monetary tightening by the Reserve Bank of India also helped secure macroeconomic stability after nearly five years.

That hard-earned stability does not seem to be at risk—despite the latest numbers on inflation and the current account deficit. The more serious problem is economic growth. It is right now devilishly difficult to figure out how much of the sharp decline in economic momentum is structural and how much is a cyclical blip because of the two consecutive exogenous shocks given to the economy—first demonetization and then the transition to GST. The economy should be able to claw back some of the lost ground as the effects of these two shocks abate, especially if there is no hysteresis. In other words, do not brush aside the possibility of a pleasant surprise in the next two GDP releases.

But that is not the entire story.

There is an important structural element to the economic slowdown as well. The Indian economy began losing momentum well before the demonetization decision was announced in November. The question is what is to be done. This newspaper continues to believe that the answer does not lie in either dramatic interest rate cuts or a large increase in the fiscal deficit. Economic stability is a public good that is difficult to secure but easy to gamble away, especially in an election season.

The key to a sustainable recovery is the investment cycle. The private sector is still struggling with excess leverage. The banks are struggling with bad debts. Capacity utilization figures show that higher demand can be met through existing capacity. The clean-up of the banks seems to have begun in earnest, though it is hard to see how the job can be done in less than two or three years.

The macroeconomic strategy will thus have to delicately balance between the need to push public investment on the one hand and keep the fiscal deficit under check on the other. And remember that the state governments today collectively account for more of the public investment than New Delhi does, and many of them seem to be snipping their capital spending plans to release money for farm loan waivers.

So where can the money come from?

First, the extra taxes that the GST is expected to send into the treasury should hopefully create fiscal space for higher public investment.

Second, the government should push ahead with a privatization programme that should be used as a way to switch assets—from airplanes to roads, for example.

India may see a small cyclical recovery in the months ahead. However, a sustainable recovery will depend on investment activity. Public investment will have to hold the fort till the private sector deleverages, banks are cleaned up and excess capacity is worked out of the system.

Do you expect a revival of economic growth in the next GDP release? Tell us at views@livemint.com

END