India’s imminent economic crisis

Poor macroeconomic management, both by the central bank and political regimes over the past several years, is leading India toward an imminent vicious cycle of low growth and high inflation, making it exceedingly vulnerable to emerging domestic and geopolitical risks. The low growth-high inflation scenario will lead to higher fiscal and current account deficits, consequent capital outflows, a weaker currency and a lack of confidence in the economy among investors. The authorities need to undertake meaningful structural reforms and loosen monetary and exchange rate policy at the earliest to arrest the decline before it culminates in an external and financial crisis. A loose fiscal policy (increased government expenditure) at this juncture with a likely low fiscal multiplier would be counterproductive and accelerate the pace of economic decline.

Economic growth in India has likely been lower than the 7% rate that has been estimated by the Central Statistical Authority for the past two-three years. A sustained 7% gross domestic product (GDP) growth has been inconsistent with other major indicators, including credit, investment, index of industrial production, and exports growth slowing for at least the past four years. A slower 5.7% official GDP growth in 2QFY18 is therefore not surprising. In fact, before the switch to a new series of GDP numbers in early 2015, GDP growth estimates were 4.7% for FY14, according to the old series. New methodology introduced in the new series raised them to 6.7% for FY14, inconsistent with other indicators. Amongst other flaws, value added in manufacturing, which has been consistently significantly higher than other indicators would suggest, is arrived at from a corporate financial database maintained by the ministry of corporate affairs. It would be impossible to arrive at a true measure of value added in manufacturing from financial accounting data for even a few large firms such as Reliance, especially in an era where production of goods and services is becoming increasingly integrated.

Economic output and growth depend mainly on productivity growth and on increases in labour and capital; most commentators mistakenly tend to focus instead on the uses of this output—consumption, investment and exports. Productivity growth, the main driver of growth, depends on structural reforms that would require better institutions and improving human skills.

Structural reforms are reforms aimed at changing the structure of the economy to make it more market-oriented, and consequently efficient and productive. India needs to focus on reforms in several areas—liberalizing markets, legal, civil service, tax structure, financial sector, education, and labour, amongst others. In competitive markets, any price different from the market-determined one (e.g. controls such as minimum or maximum prices) leads to a decline in output, ensuring reduced GDP.

To foster higher economic growth and job creation, the authorities need to focus on productivity enhancing structural reforms that would encourage the private sector—domestic and foreign—to invest in India. Specifically, the innumerable controls on markets and administered prices need to be freed up, including food and agricultural prices, water, electricity, pharmaceuticals, fertilizers, seeds and railways, amongst others that reduce output and lead to a misallocation of resources. The direct tax structure needs to be simple and transparent with retrospective taxes eliminated. Public sector banks need to be recapitalized and privatized. The education system needs to be opened up to investors—domestic and foreign—as a profit-making sector, both at the school and higher education levels. These are minimal measures to attract investments.

The inexplicably tight monetary policy of high interest rates and overvalued exchange rate have been damaging to the economy. The insistence of the Reserve Bank of India (RBI) to engage in foreign exchange market intervention to maintain an overvalued currency has encouraged further volatile debt inflows. This has increased India’s external vulnerability and inhibited financial markets development.

Overall, RBI’s high interest rate and overvalued exchange rate policy has hurt credit growth, especially to industry, hurt firm-level debt sustainability and in turn bank balance sheets, and damaged exports and domestic industry further via cheaper imports. India is the only major economy in Asia with a negative credit gap (deviation from trend), according to the International Monetary Fund.

Fiscal policy has largely been unimaginative and a tighter fiscal policy with tight monetary policy has meant no policy support for growth over the past several years. Tax policy has mainly been one of raising tax rates—excise duties on petrol and diesel mainly and service tax rates that have increased from 12% to 18% over the last three years. At the same time, little effort has been made to simplify tax rules; indeed, the new goods and services tax structure with multiple rates is the most complicated globally. This structure with a smattering of controls has kept money out of India.

The fiscal multiplier is low; around 0.3 for emerging economies, according to some estimates. This means an increased fiscal expenditure of Rs40,000 crore (0.3% of GDP) being mentioned in the press would yield a negligible additional growth of 0.1% to GDP, raising growth from 5.7% to 5.8%.

The costs of this misguided fiscal expansion (government expenditure) could be significantly high. It would not lead to sustainable growth or increased investments from the private sector. The larger fiscal deficit, along with slowing growth reducing tax revenue, and a consequent worsening fiscal situation would lead to more borrowing from the RBI. At the same time, the deteriorating economic situation would lead to capital outflows, slowing the economy further, draining liquidity from the system and raising interest rates, further dampening economic growth.

To conclude, the government needs to undertake structural reforms on a war-footing to encourage investments to grow the economy and increase revenue growth. Interest rates need to be reduced by the RBI. Misadventures such as expansionary fiscal policy will not be sustainable and will lead to low growth, higher fiscal deficit, high inflation, less competitiveness that would trigger capital outflows and lead to an external and also a financial crisis if financial sector weaknesses are not addressed.

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