2012 will be better

What doomsayers don't say: a contrarian's forecast for the Indian economy

ADITYA PURI

WHEN times are hard, doomsayers are aplenty. The problem is that if you listen to them too carefully, you tend to overlook the most obvious signs of change. 2011 was a bad year. Can 2012 be any worse? Doomsday forecasts are the easiest thing to make these days. So let's try a contrarian's forecast instead.

Let's start with the global economy. We have seen a steady flow of good news from the US. The employment situation seems to be improving rapidly and consumer sentiment (reflected in retail expenditures on discretionary items like electronics and clothes) has picked up. If these trends sustain, the US might post better growth numbers for 2012 than the 1.5-1.8 per cent being forecast currently.

Japan is likely to pull out of a recession in 2012 as post-earthquake reconstruction efforts gather momentum and the fiscal stimulus announced in 2011 begins to pay off. The consensus estimate for growth in Japan is a respectable 2 per cent for 2012.

The "hard-landing" scenario for China remains and will remain a myth. Growth might decelerate further from the 9 per cent that it expected to clock in 2011 but is unlikely to drop below 8-8.5 per cent in 2012.

Europe is certainly in a spot of trouble. It is perhaps already in recession and for 2012 it is likely to post mildly negative growth. However, financial markets' expectations from the succession of summits have been unrealistic. What they fail to recognise is that a complex thing like fiscal unification across economies cannot happen overnight. Each summit has brought incremental gains and over time considerable progress has been made. The risk of implosion has dwindled over the last few months — peripheral economies like Greece, Italy and Spain have new governments in place (led in Greece and Italy by highly respected technocrats) and have made progress towards genuine economic reform.

Even with some of these positive factors in place, we have to accept the fact that global growth in 2012 will be tepid. But there is a flipside to this. Softer growth means lower demand for commodities and this is likely to drive a correction in commodity prices. Lower commodity inflation will enable emerging market central banks to reverse their monetary stance. China, for instance, has already reversed its stance and has pared its reserve ratio twice. The RBI also seems poised for a reversal in its rate cycle as headline inflation seems well on its way to its target of 7 per cent for March 2012. Let's hope they reduce CRR to ease liquidity (bank's cost) on January 24.

That said, oil might be an exception to the general trend in commodities. Rising geopolitical tensions, particularly the continuing face-off between Iran and the US, might lead to a spurt in prices. It might make sense for our oil companies to hedge this risk instead of buying oil in the spot market. We better get a clear energy policy: for starters, politicians should combine to remove subsidy on fuel.

As inflation fears abate and emerging market central banks begin to cut rates, two things could happen. Lower commodity inflation would mean lower interest rates and better credit availability. This could set a floor to growth and slowly reverse the business cycle within these economies. Second, as the fear of untamed, runaway inflation in these economies abates, the global investor's comfort levels with their markets will increase.

Which of the emerging markets will outperform and who will get left behind? In an environment in which global growth is likely to be weak, economies like India that have a powerful domestic consumption dynamic should lead; those dependent on exports should, prima facie, fall behind. Specifically for India, a fall in the exchange rate could not have come at a better time. It will help Indian exporters gain market share even if global trade remains depressed. More importantly, it could lead to massive import substitution that favours domestic producers. This import substitution seems to be happening quite rapidly already if one goes by anecdotal evidence available from the SME segment.

Let's now focus on India and start with a caveat. It is important not to confuse a short-run cyclical dip with a permanent derating of its long-term structural potential. The arithmetic is simple. Our growth rate can be in the range of 7-10 per cent depending on policy action. Ten per cent if we get everything right, 7 per cent if we get it all wrong. Which policies and reforms are critical to taking us to our 10 per cent potential? In judging this, let's again be careful. Let's not go by the laundry list of reforms that FIIs like to wave: increase in foreign equity limits in foreign shareholding, greater voting rights for institutional shareholders in banks, FDI in retail, etc. These can have an impact only at the margin. We need not bend over backwards to appease the FIIs through these reforms — they will invest in our markets when momentum picks up and will be the first to exit when the momentum flags, reforms or not.

The reforms that we need are the ones that can actually raise our sustainable long-term growth rate. These have to come in areas like better targeting of subsidies, making projects in infrastructure viable so that they attract capital, raising the productivity of agriculture, improving healthcare and education (focusing on skill formation), bringing the parallel economy under the tax net, implementing fundamental reforms in taxation like GST and the direct tax code and finally easing the myriad rules and regulations that make doing business in India such a nightmare and tackling corruption. A number of these things do not require new legislation and can be done through executive order.

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Is this merely a wishlist for the long term or can we see some change happening in the near future? It is naïve to believe that economic decision-making in India can be divorced from the compulsions of realpolitik. Five states go into elections over the next few weeks, including heavyweights like Uttar Pradesh and Punjab. As these elections get over in the first week of March, the cycle is likely to turn with economics dominating politics rather than the other way round. Greater clarity is likely to emerge in areas like power, mining, FDI, agriculture, infrastructure and on institutions to handle corruption. Watch the budget.

What other positive trends could emerge in 2012 and over the medium term? First, the government has been beaten up too much on the issue of the fiscal deficit. The experience of the European economies (where the insistence on austerity has set off a vicious cycle of low growth and further fiscal deterioration) should surely lead us to take a fresh look at the wisdom of trying to push through sharp fiscal corrections in the middle of a downswing. Thus we should not lose too much sleep over the slippage in the fiscal deficit in the current fiscal year. It is reasonable to believe that the fiscal deficit is likely to peak in 2012 and slowly decline.

In this context, it is important to have a clear understanding of what the food security bill (the pet hate of all fiscal fundamentalists) actually entails. The expenditure on food security is not yet another expense tacked on to the budget. There appears to be a serious attempt to consolidate other programmes into the new avatar of food security so that the additional net spending (now pegged at Rs 27,000-30,000 crore) on this should be manageable. We should see consolidation in other expenditure areas.

We cannot have two Indias and, therefore, the underprivileged must be helped. Schemes like MNREGA or food security are our first real attempt at creating sustainable development schemes for the underprivileged. This will not only achieve equity in income distribution but this is the only way to get to a sustainable 10 per cent growth mark. That has to be good economics. However, we need to fix the implementation of all subsidy schemes so that they reach the intended beneficiaries and are not funded through increasing deficit.

We have done a bad job on infrastructure. Here again what is needed is known and in most cases not so difficult to handle. The powers that be seem to indicate that problems will be fixed — it would be a pity if they are not.

Finally, a word on the scare in the financial markets about a rapidly expanding provisioning cycle that Indian banks will have to reckon with over the next couple of years. Current forecasts of non-performing loans seem grossly exaggerated. We will see an uptick in NPAs providing for which is well within the capacity of Indian banking system and there is no systemic risk.

In conclusion, I reserve the right to be wrong but prefer to be positive in terms of our future while leaving the past behind.

The writer is managing director of HDFC Bank

express@expressindia.com