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Against the idea of 'India fatigue'

While the scope for adjustment is limited, there's room for some monetary policy manoeuvre that will send credible signals that India is keen on supporting growth

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The India bears are at it again. A recent *Economist* cover story claimed that India is losing its magic. There's hardly a commentator writing on India who doesn't expound on "policy paralysis" and its impact on India's economy and governance. However, these dire prognoses perhaps need to be taken with a pinch of salt given India's good "karma".

Disappointment is the flip side of expectation. Those who expect India to post close to 9% growth annually irrespective of what's happening in the rest of the world would have a reason to be disappointed. Realists, however, would see the deceleration in the Indian economy in the past couple of years as the inevitable consequence of a larger global dynamic. Again, those who believe that the Indian government can take quick, unilateral decisions guided entirely by textbook principles, will find "policy paralysis" lurking in every corner. Those who care to be more sensitive to the pulls and pressures that characterize every democracy, will see it as an integral part of the democratic process.

This is not to suggest that we can't do better. In fact, it's an opportunity for India to claim its place in the sun. Europe is plagued by sovereign debt problems. Besides, the industrial and service sector growth figures for Germany (demonstrated contraction in March) showed that Europe's woes aren't confined to peripheral economies such as Greece or Portugal. Core economies such as Germany and France run the risk of being sucked into the vortex of recession.

China, the torch-bearer of global growth over the past decade, shows distinct signs of sagging under the combined weight of tight monetary policy and gross over-investment in areas such as export capacity, infrastructure and housing. The Chinese government has forecast a 7.5% growth rate for 2012 which, by China's standards, constitutes a major slowdown. There's also a risk that a cyclical downturn in the economy will expose some of its chronic structural problems hidden behind the veneer of high growth—the massive amount of bad loans that its banks hold (over 20% of its loan portfolio according to some estimates) and its large stock of over-priced, underutilized housing.

The US might have posted some encouraging economic data recently. Its unemployment rate has come down from a peak of 10% in 2009 to 8.2% this March. But the jury is out on whether this improvement will sustain and if it does, how robust will the recovery be. The US central bank chairman Ben Bernanke seems far from sanguine that the economy is out of the woods. His prognosis is that the central bank needs to hold the policy interest rate at close to zero at least until 2014. Besides, the US government's debt is close to 100% of its gross domestic product (GDP) and unless American policymakers put together a strategy for fiscal consolidation, there would be uncertain times ahead.

Given the global context, India's economic prospects with a growth of 7% are encouraging. Consumer demand is holding up and new opportunities are emerging in rural markets. If inflation follows its current downward trend, real incomes will rise and so will discretionary consumer spending. A rising current account deficit, at 4.3% of GDP for Q3FY12, might have raised a scare but remittance flows, non-resident Indian (NRI) deposits, external commercial borrowings (ECBs) and foreign direct investment have stayed healthy. Private transfers, for instance, grew by a strong 30% for the year in Q3FY12 while net inflows under NRI deposits came in at $3.3 billion against a mere $0.2 billion a year ago. Meanwhile, ECBs in April-December totalled $10 billion, little changed from inflows the previous year. This will possibly ensure that we're insulated from a balance of payments crisis.

The central government's debt-to-GDP ratio will be down to only 45% this year and if state debt is factored in, the overall government debt-to-GDP ratio will be lower than 65%. There are signs that key infrastructure segments such as roads are seeing some pick-up in investments and the government seems committed to sorting out the hurdles in the power sector. The problem areas are exports (grew at only 8% in H2FY12 against 44% in the first half) and private investment demand, where high interest rates, an uncertain global environment and lack of clarity on domestic policy seem to be biting.

If we get our policy act together (we all know what needs to be done), it may not be difficult to cross the 8% growth threshold. Were that to happen, India would emerge the best performer among major economies. Foreign investors have adopted a "wait and watch" stance on India. They are open to the idea of topping up their India portfolios but are awaiting some clarity on economic governance before putting money on the table. If we can send a credible signal that policy is moving in the right direction, we could see a flood of foreign investments.

A surge in foreign capital by itself will solve a few of our problems quickly. The anxiety over funding our hefty current account deficit will abate. This would trigger a much-needed appreciation in the rupee and counter some of the inflationary pressures emerging from high oil prices.

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But to get our economics right, we need to set our political house in order. The current impasse in Indian politics and its drag on economic decision making stem from the fact that rival political entities are digging their heels deeper into positions that are already well-entrenched. Thus the opposition seems to believe that its sole "dharma" is to oppose whatever the government proposes, even if this goes against a larger collective interest. Regional parties are focused purely on narrow local issues. They are quick to raise a red flag whenever they imagine that national economic policy has the slightest chance to impinge on their local interests.

This stalemate can only be broken if politicians of all hues take an enlightened view of the larger national interest reach across political aisles and work towards a consensus on key economic policies. For instance, it's imperative to forge some agreement across party lines on fuel price rationalization. The under-recovery on a litre of diesel hovers at around ₹11 and if something is not done urgently, either subsidies will balloon or the oil marketing companies will go bust. More fundamentally, subsidizing fuel is antithetical to the very idea of conservation.

States might appear to lose autonomy in revenue collection with the implementation of the goods and services tax. However, a single-point tax will plug most of the leakages in the indirect tax apparatus and is likely to lead to significant revenue buoyancy as happened with the introduction of value-added tax. State governments, the centre and the opposition need to think beyond politics and figure out whether the hard economics of these reforms work in the nation's (and by extension the states') favour. The direct taxes code, still pending in Parliament, too, could revolutionize our direct tax regime by removing exemptions and increasing compliance. It's imperative for our long-term fiscal health and deserves support across the political spectrum.

These actions, if implemented, can add between half to a percentage point to our GDP growth. The alternative is to see our rank slip down the global league tables and lose out on the potential gains in poverty reduction and employment generation that growth, coupled with the right redistributive policies, can bring.

Finally, the Reserve Bank of India (RBI), too, may have to play an active role both in directly facilitating growth and helping change sentiment among companies and investors. Its stance in the past that untamed inflation hurts growth in the medium term was legitimate. The central bank's attack on inflation (it hiked policy rate 13 times) has paid off. Inflation has moderated from its peak of over 10% in Q3FY12 to 7% in February. It's likely to come down further in March and stay in this range for the foreseeable future. Core inflation, the proxy for pricing power of companies, has also come down sharply. In December 2011, it was close to 8%; in February, it was lower than 6%. In short, companies have seen a cutback in their ability to hike prices.

The collateral damage of this war on inflation has been heavy. Monetary growth has slackened to 13.5% in March and even supporting a 7% growth rate in the economy has become a challenge. The visible manifestation of this is a massive liquidity deficit in the system and slow deposit growth.

In March, banks borrowed ₹180,000 crore a day from RBI to bridge their liquidity deficit. This deficit has affected both the availability and the cost of credit and is unlikely to improve on its own. The presence of a hefty government borrowing programme (budgeted at ₹570,000 crore) will only compound the problem. Thus, RBI needs to ensure that the shortage of money does not derail growth further through cuts in the cash reserve ratio and repo rate, which will bring down the cost of borrowing in the economy.

A shift in the priorities for RBI from inflation to growth will help boost investor and corporate sentiments. Physical investments in capacity expansion, the missing piece in our growth jigsaw, are likely to pick up if companies see a significant decline in their capital cost. This will not only take growth past the 7.5% mark, it will also create adequate capacity to absorb demand pressures in the medium term so that rising demand in the future does not necessarily translate to high inflation.

There's also a need to send out a positive signal. While the scope for any adjustment in the fiscal space is limited at this juncture, there's enough room for some nimble monetary policy manoeuvre which will send quick and credible signals that the country is keen on supporting growth.

Thus the ball is unfairly in the central bank's court. If it's too cautious in its approach and wishes to guard against all possible risks of a U-turn in inflation's current path, it also runs the risk of compromising on growth prospects. The time has probably come for a forward-looking monetary policy that bets on moderating price pressures and recognizes that without substantial easing, there's a growing risk of choking growth.

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