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Macroeconomic Environment in India: The Role of Fiscal and Monetary Policies[1]

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The global context of India's growth story

India's growth story remains highly attractive at a time of fragile global economic recovery, uneven growth, and tremendous uncertainty surrounding global markets. IMF has lowered the projection of world gross domestic product (GDP) growth to 3.2 per cent in 2016. Most countries continue with large quantitative easing. While the growth and employment figures in the United States show signs of recovery, it has not yet led the Federal Reserve to increase the interest rate, though action on this front is expected sooner than later. The European Union continues to struggle and with Brexit, recovery has only got prolonged. Brexit has added to the woes of the European Union and Great Britain is struggling with the onslaught of unwanted migration and refugee crisis. Japan continues to struggle and even with long periods of negative interest rates, recovery does not seem to be in the horizon. China has been struggling and with the real volume of debt unfolding, we may not see acceleration in growth anytime soon. In this environment, India is the fastest growing country among the larger countries in the world and despite being much lower than the potential, the growth performance has been lauded.

According to Government of India and the Reserve Bank of India, the Indian economy is expected to grow at 7.5 per cent this year. In the first quarter the estimated year-on-year growth in GDP at 7.1 per cent was the lowest growth observed in the last six quarters. Gross Value Added (GVA) at 7.3 per cent shows that the economy has not been decelerating however the growth scenario is stagnant. The sectors that have decelerated in growth performance from the previous quarter are agriculture (from 2.6 per cent to 1.8 per cent), mining and quarrying (from 8.5 per cent to minus 0.4 per cent) and construction (from 5.6 per cent to 1.5 per cent). In contrast, manufacturing and other utilities have shown some acceleration. Going further, with better monsoon and sharply increasing acreage under kharif cultivation by almost 30 per cent, increased investments in roads and railways and public sector pay revision are likely to accelerate growth. This could potentially exceed the official estimate and even touch the 8 per cent speculated by the Vice Chairman of NITI Aayog, Dr. Arvind Panagariya.

The relatively optimistic performance has led Indian policy makers to claim that if India can grow at over 10 per cent, GDP will rise from the present $2 trillion to $8 trillion by 2030. In fact, NITI Aayog is busy preparing the Vision Document for 15 years putting together aspirational goals, and has been working on a strategy document for 7 years and its implementation plan for 3 years. There are few instances of a country achieving double digit growth for a prolonged period of time. China achieved double digit growth for 30 years starting in the early 1980s, but in an authoritarian environment. Achieving such a feat in a democratic environment is a formidable challenge.

Even as the economy has shown some green shoots, the sharply decelerating trend in investment remains a matter of serious concern. The gross fixed capital formation in absolute terms actually declined by 3.1 per cent during this quarter compared to the decline of one per cent in the previous quarter. This indicates that the investment climate remains worrisome. This also shows that industrial growth continues to be consumption-led rather than investment-led. If growth in public administration is excluded, the growth of GVA during the quarter works out to just 6.6 per cent.

Taking the economy to a higher growth trajectory over the medium and long term requires considerable reforms by the government. In the short term, measures to clean up the balance sheets of financial institutions and corporates will weigh the policy matrix. With the bankruptcy law enacted and Asset Reconstruction Company in place, the initiative has been taken and now implementation holds the key.

The medium term measures will have to be directed at improving the investment climate to raise the level of savings and investment in the economy which will require structural reforms. In particular, increasing employment in the organised sector in the wake of significant addition to the labour force is possible only when labour intensive manufacturing activity accelerates. While the focus so far has been to deal with legacy problems arising from the twin balance sheet crisis, the time has come for the government to embrace big ticket reforms. “Make in India” will not succeed until the issue of labour market flexibility and land acquisition are addressed. There is no reason for the government to hold on to public enterprises unless they serve a strategic objective. The Union government will have to goad the states into streamlining the system for improving the ease of doing business. Hopefully, with the success found in the passage of Goods and Services Tax (GST) Bill, the government will gear up to embark on these important structural reforms.

As mentioned above, achieving accelerated growth in a sustainable manner for a prolonged period to improve the living conditions of the people requires reforms in both policies and institutions. In a democratic polity achieving a consensus on the reform agenda is not easy and even when the broad contours of reforms are agreed upon, it is a challenge to implement them. Of course, Lord Keynes eloquently stated, “I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. ….Sooner or later, it is ideas, not vested interests, which are dangerous for good or evil”. However, experience has shown that policy reform in any country often becomes a hostage of special interest groups. Not surprisingly, there is tyranny of status quo in reforms because, those who gain from reforms are ungrateful and those who lose are vengeful. Suffice it to say that unless the factor and product markets in the country are freed from imperfections, the growth performance will always remain below the potential. These include greater flexibility in labour, land and capital markets, creating conditions for a competitive market and allowing the markets to determine prices rather than subjecting them to various types of controls.

Admittedly, the sources of growth in Indian economy continue to be private and public consumption and not investment. While public investment has been constrained by fiscal responsibility targets, the private investment has simply failed to take off due to the twin balance sheet crisis. The stagnant revenues on one hand and the inability of the government to control proliferating wages and salaries, interest payments, subsidies and transfers on the other have left very little fiscal room for increased public investment. Due to the lack of fiscal room, the government has not been able to stimulate investments through public expenditures. Rather than showing an increase, investments have shown a steady decline since 2009-10. The gross fixed capital formation in the country has shown a steady decline from almost 38 per cent of the GDP in 2008-09 to less than 30 per cent in 2015-16. The more recent data on index of industrial production only confirms the continuation of the trend.

The commercial banks are saddled with non-performing assets in their balance sheets and are unwilling to lend. The balance sheets of infrastructure companies which have borrowed heavily from the banking system also do not show signs of improvement due to many of the projects stuck at various stages. Not surprisingly, the manufacturing sector growth continues to be a matter of concern. Although the bankruptcy law has been enacted and asset restructuring company has been set up, very little action in terms of effective resolution has taken place. The Kelkar Committee has made significant recommendations on the framework to renegotiate the revival of the stuck PPP projects in November 2015.

There is a natural clamour for reducing the rate of interest in the country to revive investments. While there are many factors that determine the volume of investments in a country, the rate of interest is an important factor. Keynes, in his seminal and most influential work in the post-depression era “The General Theory of Employment, Interest and Money” stated that when marginal efficiency of capital or expected rate of profit is lower than the rate of interest, the investor will shy away from making investment. Therefore, investment activity will pick up either when the expected rate of return on the investments of capital increases or the rate of interest declines.

Despite several initiatives to improve the ease of doing business through more responsive governance, and initiatives like “Make in India” and “Start-up India”, private investment remains subdued. The stagnancy in global demand does not help matters and the Indian commodity exports have shown a continuous decline for almost 18 months since January 2015. The legacy of stalled projects and debt overhang in many infrastructure projects and the difficulties in fuel supply and land acquisition have a cast a long shadow. As mentioned earlier, the source of the recent growth has been consumption demand which cannot be sustained for long.

In this environment, the two major proposals that are being made are to increase the public investment substantially to trigger the revival of investment demand and second, to reduce the interest rates to lower the cost of capital to make investment. The former is stuck due to the inability of containing public consumption demand on one hand and the lack of fiscal space created by the Fiscal Responsibility and Budget Management (FRBM) legislation on the other. Indeed, the Keynesian solution in an environment when the aggregate demand is low is to revive it through public consumption and investment expenditures without bothering about the deficits if necessary by monetising the deficit. Thus, a combination of fiscal and monetary policy is supposed to be used when the economy is stagnant.

The other option to is to accelerate private investment by reducing the interest rates, which falls in the realm of monetary policy. However, RBI which calibrates monetary policy has the objective of price stability and therefore, keeps a control over money supply. The adoption of inflation target at 4% plus or minus 2 percent does not provide much leeway in increasing money supply. In addition, there is the agreement between the RBI Governor and the Union Secretary of Finance in 1996 that they will stop monetising the deficits. Of course, this has brought considerable discipline in monetary policy calibration; and at the same time, it has also brought in rigidity in the calibration of monetary policy. Thus, we have a situation wherein expansionary fiscal policy is constrained by FRBM targets and expansionary monetary policy is regulated by the inflation target and accompanying constraint on money supply expansion.

Naturally, there are differences between the monetary and fiscal authorities. The Ministry of Finance would like the Reserve Bank of India to reduce the interest rates to trigger the investment cycle while the latter complains about the lack of lending space with overwhelming proportion of household savings being used up by the government sector. The FRBM target of 6 per cent of GDP for the Union and states was proposed by the 12th Finance Commission based on the fact that the household sector's financial savings as a ratio of GDP averages at about 10 per cent. It may be noted that only the household sector generates a saving-investment balance as both government and corporates have negative balance between saving and investment and have to depend on the household sector's financial savings for their investment requirements. With the surplus savings from the household sector of 10 per cent and with the foreign investments estimated at 1.5 per cent, the total available savings for investment as a ratio of GDP is estimated at 11.5 per cent. Of this, if the government pre-empts 6 per cent and public enterprises take 1.5 per cent, the private sector will be left with 4 per cent of GDP for its investment. Therefore, the fiscal deficit target was fixed at 6 per cent. The 13th Finance Commission reduced the overall fiscal deficit target to 5.4 per cent as 3 per cent of GDP for the centre and 3 per cent of Gross State Domestic Product (GSDP) for each of the states works out to 5.4%. However, as of 2015-16, the household sector's financial saving has declined to 7.7 per cent. At the same time, the aggregate fiscal deficit is higher at over 6 per cent of GDP; about one per cent of GDP is pre-empted by special institutional agencies like National Highways Authority of India (NHAI), Railways and National Bank for Agriculture and Rural Development (NABARD) for making additional investments. The public enterprises will demand an additional 2 per cent of GDP leaving very little lending space to the private sector.

Then there is the issue of reluctance of the banking system to lend to the private sector, particularly by public sector banks due to their own balance sheet crisis. The 36 Scheduled Commercial Banks accounted for 93 per cent of the gross advances. Consequent to the asset quality review (AQR), the gross non-performing advances (GNPA) increased from 5.1 per cent in September 2015 to 7.6 per cent in March 2016 and the increase in net non-performing advances (NNPA) as a ratio of net advances was from 2.8 per cent to 4.6 per cent during the corresponding period. Much of this was due to the increase in public sector banks. Their NNPA as a ratio of net advances increased from 3.6 per cent to 6.1 per cent during this period. It is not clear how much of this is due to deterioration in the six months and how much is due to the AQR. In fact, the macro stress tests done by the RBI shows that GNPA may increase from 7.6 per cent in March 2016 to 8.5 per cent in March 2017 and if the scenarios deteriorate further, it might further increase to 9.3 per cent in by March 2017. The GNPA of the PSBs may go up from 9.6 per cent in March 2016 to 10.1 per cent by March 2017 and under a severe stress scenario, it might even reach 11 per cent by March 2017. The financial stability brought out by the RBI also states that large borrowers (more than Rs. 5 crores) access 58% of the total advances of scheduled commercial banks.

In this environment, it is too optimistic to assume proactive lending by commercial banks. Thus, even if the Reserve Bank reduces the interest rate, it may not be transmitted to borrowers partly due to lack of adequate lending space and partly due to the reluctance of the banking system itself. Indeed, it is important to get the stalled projects going. The PPP stalled projects in infrastructure should be renegotiated on the basis of the framework provided by the Kelkar Committee. Although not much has happened since the passing of bankruptcy laws and creation of Asset Reconstruction Company, some revival may happen in the medium term. The more favourable monsoon this year after two successive years of drought may also revive agro-based industries and revival of rural demand could improve the consumer goods industries.

However, it would be too optimistic to think that these factors will revive the industrial climate immediately and therefore, it is important to augment investment by the public sector. Perhaps the way forward is to make investments through special purpose vehicles. Given the constraints on the availability of lendable space, perhaps in the near term, there is no alternative but to calibrate financing of the deficits by augmenting liquidity through open market operations. In this sense, perhaps, both RBI and the Finance Ministry may have to take a moratorium on their agreement not to monetise the deficits.

In conclusion, revival of the investment climate in extremely important for transforming India into an economic power in the medium and long term. It is here that both Finance Ministry and Reserve Bank have a challenging task in calibrating fiscal and monetary policies in a coordinated manner. This also implies that the time for business-as-usual (BAU) is over and the government expenditure policy should focus on achieving allocative and technical efficiency. Hope, the government will walk the talk for a better India.

[1] This essay is a lecture given by Dr. M Govinda Rao on the macroeconomic environment in India, held at the Indian Institute of World Culture, Bengaluru. The lecture was held in honour of the noted economist, PR Brahmananda, who is credited with the introduction of the Vakil-Brahmananda wage-goods model.

Professor PR Brahmananda made significant contributions to India's monetary policy and international trade. His contributions to development planning through the wage goods model is relevant even today. Prof. Brahmananda is credited with bringing lustre to an otherwise dull discussion on economic policy by coining unpleasant epithets like, "shortage economy", "futureless economy", and christening events like "fullmangal" and "semibombla."

Prof. Brahmananda's professional life was devoted mainly to analyse the macroeconomic environment and development policy issues in the country. He had considerable concern with the liberal application of Keynesian remedies to accelerate growth and create employment. At the same time, he was not a Friedmaniac. He supported a judicious mix of monetary and fiscal policies. Keeping Prof. Brahmananda's interests in view, this essay covers India's macroeconomic environment and role of fiscal and monetary policies.

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