

Macroeconomic Policies for India's Growth Crisis

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Instead of focusing on predetermined fiscal targets that are unlikely to be realised, India's fiscal adjustment should be calibrated to the recovery and a rebalancing of demand from the public sector to the private. This is best done by targeting the structural rather than the cyclical fiscal deficit. There should also be a sharp shift in the composition of the deficit from consumption to addressing supply-side bottlenecks through public investment in infrastructure. Unlike public consumption which can crowd out private demand, public infrastructure investment has higher fiscal multipliers and can crowd in private investment.

India's growth has dipped sharply and continuously over the last seven quarters, from 9.9% in Q₄ 2010-11 to an estimated 4.5% in Q₃ 2012-13. While the global economy itself is in crisis, the sharp decline in Indian growth has come somewhat as a surprise because of its putative domestic demand-driven model of growth. The stylised mainstream view in India on how to manage the current crisis appears to be that policy measures to return to trend growth entail a "virtuous cycle" of lowering monetary policy rates and reducing the fiscal deficit over the short term, in addition to addressing structural supply bottlenecks over the medium term. This medium-term strategy is both indisputable and critical. However, structural changes take time. The impact of short-term macroeconomic policies on the other hand can be immediate. The following arguments, which draw upon the current policy debate on crisis management in advanced economies, would show that the mix of short-term macroeconomic stabilisation policies should be quite different from their medium-term trajectory – just as in the case of the advanced economies.

Monetary Policy

The Reserve Bank of India has lowered its benchmark repo rate by 50 basis points since mid-December 2012. This, however, has had little effect on bank deposit rates. Indeed, some banks have raised deposit rates since. This is because negative real deposit rates over an extended period have resulted in a decline in financial savings, opening up a gap between credit growth and deposit growth, and in an increase in gold imports. It is true that credit growth has also declined in recent quarters along with the decline in growth, but the decline in deposits is sharper (Graph 1, p 13).

The increase in gold imports is a major factor behind the ballooning current account deficit. Negative interest rates also tend to discourage capital flows that are needed to finance the worsening current account deficit. If capital flows are nevertheless currently adequate to finance the current account deficit, this is because of easy monetary policy, including quantitative easing (QE) on a large scale in advanced economies are pushing volatile capital flows into emerging markets. This "push factor" could change anytime; it is therefore prudent to have "pull factors" also in place.

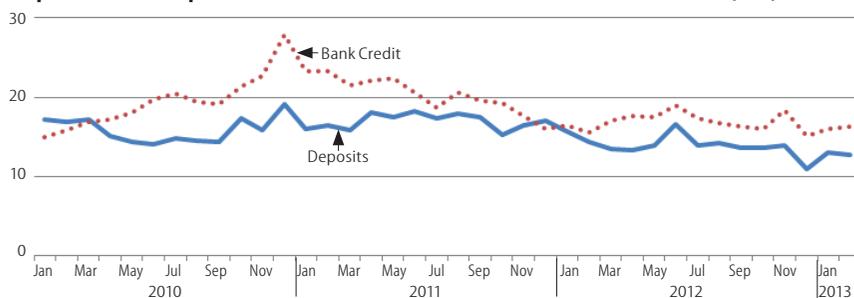
Since growth has declined sharply, it could be argued that, à la the Phillips Curve, there is a trade-off between inflation and growth, at least in the short run, and so policy rates should be kept lower than what is prudent under normal circumstances. This argument is difficult to sustain for two reasons. First, the factors keeping inflation high (food and fuel prices) are unlikely to abate soon on account of domestic supply constraints which would take time to address even if bold policy reforms are undertaken now. It is pertinent that the gap between headline inflation and core inflation continues to widen (irrespective of whether the wholesale price index (WPI) or the consumer price index (CPI) is used), whereas the gap is sharply converging in the US (Graphs 2 and 3, p 13). India's high inflation is therefore not imported. Second, the original Phillips curve has long been discredited in mainstream economics which now mostly subscribes to the augmented Phillips curve that takes account of inflationary expectations. As a result, there is no trade-off between inflation and growth even in the short run.

Would keeping (repo) policy rates at the current level act as a major drag on investment? Current policy rates in India are already lower than what the "Taylor Rule" warrants. It is true that the Taylor Rule for monetary policy was formulated through a post facto analysis of United States Federal Reserve's monetary policy actions, culminating in a statistical relationship that best fitted past episodes of "successful" monetary policy outcomes

These are the personal views of the author.

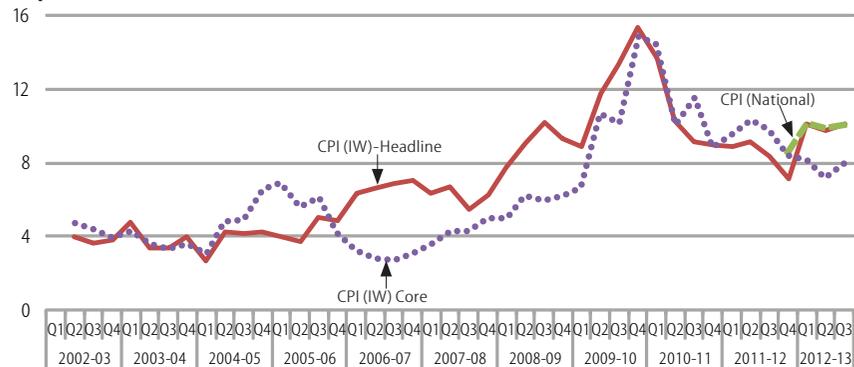
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Graph 1: Growth in Deposits and Bank Credit of Scheduled Commercial Banks in India (in %)



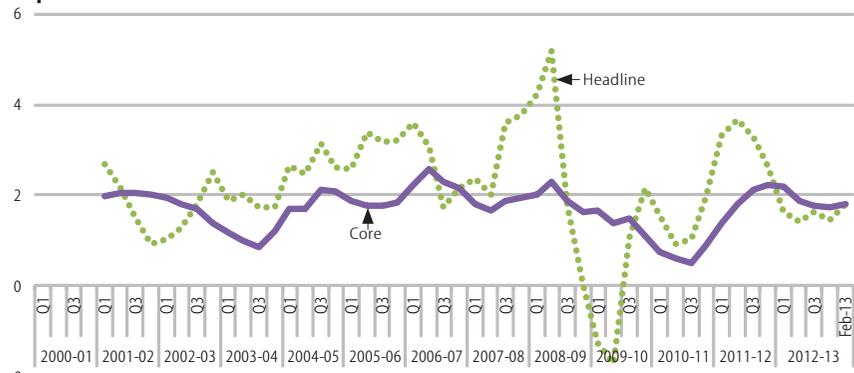
Source: Real Time Data Base, RBI.
Database on Indian Economy, Reserve Bank of India, <http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home>

Graph 2: Headline and Core Consumer Price Inflation in India



(1) CPI (IW): Base 2001 series (available from July 2001 onwards). (2) Quarterly GDP growth figures up to Q₄ of 2004-05 are from the 1999-2000 series and remaining period are calculated from 2004-05 series.
Sources: (1) For GDP and CPI (National), CSO, MoS&PI, GOI. (2) CPI (IW), Labour Bureau, GOI.
CPI (IW), Labour Bureau, GOI, <http://labourbureau.nic.in/indexes.htm>
CPI (National), CSO, MoS&PI, GOI, http://mospi.nic.in/Mospi_New/site/PressRelease.aspx?status=1&menu_id=39

Graph 3: Headline and Core Consumer Price Inflation in the US



Sources: (1) Bureau of Labour Statistics, Department of Labour, US-<http://www.bls.gov/cpi/>
(2) FRED Economic Data, St Louis Fed, US, <http://research.stlouisfed.org/>

in the US. From this it would appear that a monetary policy rule would need to be worked out separately for each economy, based on historical statistics. Estimating a non-observable moving target like “potential GDP” is also hazardous. However, if one were to nevertheless apply the Taylor Rule¹ mechanically to India, with suitable adjustments for the inflation target (5%) and potential GDP (say 8%), the predicted policy interest rate according to a back of the envelope calculation is about 7%, assuming that current GDP

growth is 5% and inflation 6% (wpi). This might indicate that the monetary policy stance is a trifle tight (current repo rate=7.5%). However, if one were to use the CPI (over 10%), used by central bankers elsewhere, the predicted interest rate would still be 13%, making the current monetary stance far too loose. Even if one were to use core, instead of headline, CPI inflation, the predicted interest rate would still be in double digits. The chief reasons for the decline in investment lie elsewhere – pessimism

regarding the external sector, stalled decision-making, growing infrastructural deficit and supply bottlenecks, and rising wages in an environment where profit margins are already under pressure because of slowing growth.

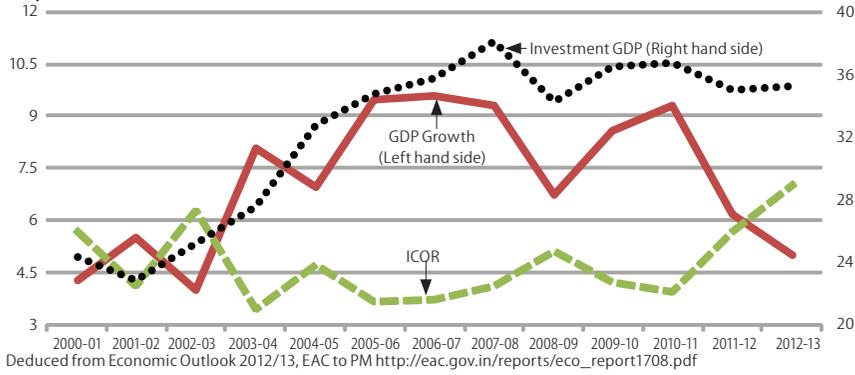
The larger point, however, is that overall investment in the economy has *not* declined sharply. What has declined sharply is the productivity of investment, or what is called the incremental capital output ratio (ICOR) – the output generated per unit of investment – which has little to do with the stance of monetary policy. Had the productivity of capital during 2011-12 and 2012-13 remained at the average of the period 2000-01 to 2012-13 (ICOR of 4.7), the growth rate in both 2011-12 and 2012-13 would have exceeded 7% (Graph 4, p 14). It is therefore more important to increase savings to reduce the increasing savings-investment gap and restore the productivity of investment, than to simply increase investment.

The bottom line is that current policy rates in India are by no means high. They need to be benchmarked to inflation to increase financial savings, keep the current account deficit within sustainable limits, and facilitate its financing. The situation in advanced economies is completely different, as easy monetary policy purports to lower/tax savings over the short term to support consumption, even as rates would need to be normalised as private demand returns. India’s problems however are not on the demand but on the supply side as its inflation record attests.

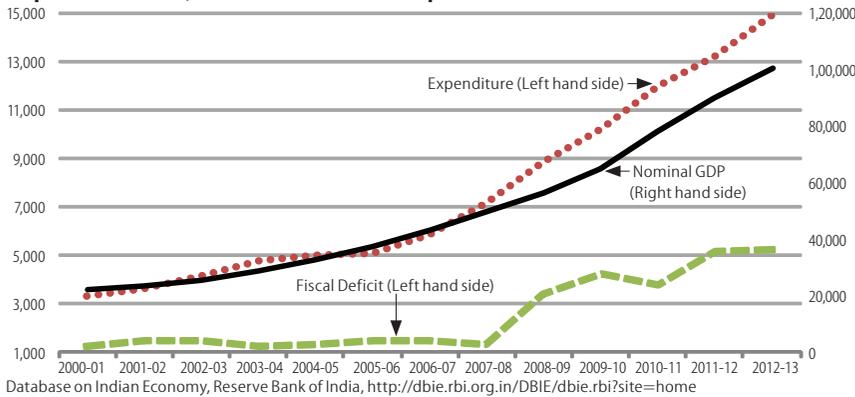
Fiscal Policy

During the economic boom the centre’s nominal fiscal deficit declined from 6% in 2001-02 to 2.5% of GDP in 2007-08. The fiscal improvement was however attributable to cyclical factors, such as increase in revenue on account of growth and the outsized denominator (GDP) rather than to structural factors such as expenditure and subsidy reforms that create fiscal space for bad times ahead when revenues dip and the denominator shrinks. Had expenditure been contained, there would have been a sharp decline in the nominal fiscal deficit on account of the increase in revenues. However, as Graph 5 (p 14) indicates, the fiscal deficit

Graph 4: Productivity Trends



Graph 5: Nominal GDP, Central Fiscal Deficit and Expenditure



did not decline in nominal terms, indicating that revenue increases were matched by expenditure increases. Hence, as growth declined, the apparent fiscal space created during the boom quickly evaporated.

The fiscal stimulus of 2008-09 was used for getting growth quickly back on track by enhancing consumption. This worked over the short run. As elsewhere in the world, there was a spectacular recovery in 2009-10 and 2010-11. The recovery could not be sustained, however, as few steps were taken for enhancing/sustaining the growth potential through investment or additions to productive capacity.

Be it as it may, it needs to be understood that the scope for fiscal correction during a sharp economic downturn is limited, as recent experience as well as the current debate in western countries make amply clear.² If the economy is growing below potential and private demand is shrinking, a contraction in government demand would only magnify the downturn, especially in a situation where external demand has also slumped.³ European economies that attempted sharp fiscal correction prematurely have relapsed into recession. As revenues and the (GDP) denominator

shrink further, fiscal correction becomes even more difficult.

It is true that India's public debt and fiscal deficit are high in relation to its developing country peers. Both need to be brought down over the medium to long term. The question is whether a deep crisis in growth is the right time to do this. "The boom, not the slump, is the right time for austerity at the Treasury", John Maynard Keynes famously remarked in 1937, just as President Roosevelt's attempts to balance the budget too soon tipped the smart us recovery into a double dip recession.⁴

India's cyclically adjusted – "structural" – fiscal deficit is lower than its current fiscal deficit. However, India's public accounts make no distinction between the two. It is also pertinent to note that the structural deficit is also lower than nominal GDP growth. Its public debt/GDP ratio has therefore been declining. Public debt dynamics in advanced economies are completely different, with debt much higher relative to national income and expected trend growth much lower. These levels continue to rise sharply because their structural fiscal deficit is higher – and cyclical deficit far higher – than nominal

GDP growth. It is therefore widely believed that advanced economies cannot grow their way out of current levels of debt, which would need to be at least partly inflated away. Unlike western countries, India's public debt relative to expected future GDP growth is not so high that it cannot grow its way out subsequently.

Conclusions

The bottom line is that instead of pre-determined fiscal targets, which are unlikely to be realised, fiscal adjustment should be calibrated to the recovery and rebalancing of demand from the public sector to the private. This is best done by targeting the structural, rather than the cyclical fiscal deficit. There should also be a sharp shift in the composition of the deficit from consumption to addressing supply-side bottlenecks through public investment in infrastructure, in addition to structural and governance reforms that have stalled existing projects and fresh investment to sustain the recovery. Unlike public consumption which can crowd out private demand, public infrastructure investment has higher fiscal multipliers⁵ and can crowd in private investment. It can therefore both put growth back on a sustainable high growth trajectory and also lay the grounds for a subsequent fiscal exit by rebalancing demand from the public to private sector. However, in view of the difficulties inherent in estimating the cyclically adjusted fiscal deficit, which is non-observable, the nominal fiscal deficit should not persistently exceed nominal GDP growth by a wide margin. This would ensure that the burden of public debt does not rise significantly in real terms.

It could be argued that an inherent danger in this strategy is that markets and rating agencies could react adversely. However, given India's relatively benign public debt dynamics, they are likely to react more sharply to a collapse in growth that worsens the underlying benign debt dynamics. They would also watch actual performance, not stated intentions. As pointed out, it is not only undesirable to attempt sharp fiscal correction during a slump, but it may also be difficult or impossible. International Monetary Fund (IMF) stabilisation programmes have been

criticised for their insistence on sharp fiscal correction at a time private demand collapsed, leading to prolonged periods of low growth. That such an approach, which flew in the face of economic theory, was primarily to protect the interests of its majority shareholders would be apparent from the fact that during the current crisis – when its majority shareholders are in trouble – the IMF is cautioning against premature withdrawal of stimulus. Incidentally, the IMF has long held up the Indian programme of the early 1990s as its poster

baby, because growth recovered quickly along with macroeconomic stability. But one of the reasons for this success was that Indian policymakers rather shrewdly bucked IMF fiscal targets while carrying out far-reaching structural reforms.

NOTES

- 1 Predicted Policy Interest Rate = Current Inflation Rate + (0.5*(Current GDP – Potential GDP)) + (0.5*(Current Inflation Rate – Target Inflation Rate)) +2. For “Taylor Rule Calculator” go to http://www.aloksheel.com/taylor_rule.htm
- 2 Luc Eyraud and Anke Weber, “The Challenge of Debt Reduction during Fiscal Consolidation”, IMF Working Paper WP/13/67 March 2013.
- 3 It is of course possible to combine strong growth with fiscal consolidation (“expansionary fiscal consolidation”), but for this either domestic private or overseas demand, or ideally both, need to be robust. BCA Research, “Europe: A Historical View of Fiscal Reform”, *Daily Insight*, 4 May 2010. <http://www.bcaresearch.com/public/story.asp?pre=PRE-20100504.GIF> The US also saw strong growth in the United States following the Reagan spending cuts of 1981 and the Clinton cuts in the 1990s.
- 4 Paul Krugman, “Keynes Was Right”, *The New York Times*, 29 December 2011, http://www.nytimes.com/2011/12/30/opinion/keynes-was-right.html?_r=1
- 5 See C Rangarajan and Alok Sheel, “Growth or Austerity: The Policy Dilemma”, *Money and Finance*, February 2013, especially section 12, pp 77-81. <http://www.icra.in/Files/MoneyFinance/Growth%20or%20Austerity.pdf>