Unfinished business

PUBLIC INTEREST

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In any reasonable country, Dr Raghuram Rajan's reputation would be that of a rate-cutting governor. Cutting rates by 125 basis points within a year, against a background of persistently high inflationary expectations, and significant exchange rate management pressures indicates quite a faith in the curative properties of low interest rates. His irritation with "savants" is thus perfectly understandable.

Having got the rate cuts demanded, attention must now focus on urgent unfinished business that the government of India and the investment community must execute.

The introduction of the monetary policy agreement with concrete inflation targets, and the successful management of exchange rate pressures by the Reserve Bank of India (RBI) and the government means that two of the three objectives of short-term macro policy have been successfully executed. This has been combined with some aggressive selling of India's potential as an investment destination. There are several signs that economic agents are responding positively. Thus, manufacturing growth, though uneven, has expanded for the past nine months. Capital formation has picked up due to revival of stalled projects. Liquidity conditions have somewhat eased.

What of the third macroeconomic policy objective, i.e. growth? Notwithstanding, quibbles regarding growth, it is unquestionable that India is growing at a faster rate than it was in the recent past, unlike other emerging economies and despite some serious external uncertainties. The question is whether this growth can be sustainably accelerated or, at least, maintained over the medium term.

This does require Indian business to respond to the recent positive trends. Currently, external investors seem to be more optimistic than our home-grown variety; India has jumped 16 places in the world economic forum competitiveness rankings, probably a factor in India becoming the top FDI destination in 2015. But, domestic businesses seem reluctant to invest in the future and continue to be addicted to short-term gains. Survey-based business sentiments have been falling, probably due to stagnant profitability of the corporate sector and sluggish domestic stock markets.

It is essential that Indian investors lengthen their telescopic foresight. If significant rate cuts, good short-term macroeconomic management, increasing FDI opportunity and benign commodity prices will not do the trick, then some serious introspection is needed.

To complement the shift in private sector attitude, the government must also address the long standing "achilles heel" of Indian macro policy: the fiscal dimension. There are three areas for immediate action. First, government should unambiguously affirm its commitment to medium-term fiscal consolidation, focusing on the eventual elimination of the central government's revenue deficit, and deliver on this affirmation in Budget 2016. This means it must resist the temptation to use increased tax revenues or lower fuel subsidy liabilities to make populist expenditures that achieve little. Instead, the government can "surprise" the markets by accelerating progress on eliminating the revenue deficit.

There is no escaping the need for the central government to stop borrowing to consume as soon as possible. Until such time as this happens, the focus on public investment should be at the state level, facilitated by the Centre, since the states typically do not borrow to consume. Eliminating the revenue deficit will provide the government the fiscal space to expand public investment and undertake serious public sector restructuring (starting with the banks). A fiscal deficit of even six per cent utilised solely for investment and asset restructuring is eminently defensible. A fiscal deficit of four per cent largely used for consumption is not. And an investment stimulus is a much more effective tool of countercyclical policy in an emerging economy with huge supply side and infrastructural bottlenecks than a consumption stimulus.

Second, business process reforms in the fiscal policy execution demonstrate like nothing else the ability of India to move to a rule-based governance framework. The reason why GST is such a hot topic is not just the benefits it brings to the single market, but also the fact that it demonstrates the government's capability to undertake business process reforms that reduce the scope for capricious discretionary action. The government must also keep its promises — lowering corporate tax rates by cutting exemptions, meeting its disinvestment targets, and demonstrating that the tax regime, three budgets down the line, is significantly less adversarial than when it took office; to think that the public and investors believe that this is currently so is just wishful thinking.

Third, the government needs to immediately embark on the development of a strategic medium-term budget formulation and execution framework and announce and implement concrete expenditure reforms to improve public service delivery. The private sector will not increase its telescopic foresight if the government continues to think in one-year bursts. A credible medium-term fiscal framework is an essential prerequisite for society to think and act optimistically about the future, which, in turn, is essential for higher, more stable economic growth.

Thus, a road map to eliminate the revenue deficit, implementing a medium-term fiscal framework and improved and less adversarial fiscal execution will add to the credibility of the government's ability to deliver promises, thereby fostering a quantitative and qualitative growth dividend.

There is more positive news about the Indian economy today than at any time this decade (unless, unlike me, you equate India's economic health with huge corporate profits or stock market returns). The government and the private sector now both need to do their bit to translate this into higher sustained growth.

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