It's the economy, stupid

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The Modi government started with much fanfare and high expectations in 2014 after unseating a corruption-ridden United Progressive Alliance (UPA) government, which had overseen high inflation and rapidly declining growth. But some three years later the engine has gone off the rails.

The economy recovered a bit in its first two years, as the Modi government benefited from a huge terms of trade windfall from declining oil prices. GDP growth, which was at six per cent in Q3 2014-15, peaked at 9.1 per cent in Q4 2015-16. The government basked in the global adulation of declining inflation and being touted as the world's fastest growing economy — faster than even China.

This huge windfall of three-four per cent of the GDP, according to the International Monetary Fund (IMF), helped Modi's economic team to ignore worrisome signs of declining private investment, and growing non-performing loans (NPLs) which have now reached over $190 billion (about eight per cent of the GDP) from around $ 40 billion when the Modi government took over, as stricter classification was forced on the banks.

But without any serious reforms and huge policy mistakes the recovery spluttered to a halt and India has now seen a decline in GDP for six quarters. The latest quarterly GDP growth of 5.7 per cent for the second quarter of 2017-18 is the slowest since the Modi government took power. Investment has dropped below 30 per cent of the GDP and despite low investment capacity utilisation is again falling.

The decline in growth started even before the Modi government unleashed demonetisation on the economy on November 8, 2016, by withdrawing 86 per cent of the country's currency overnight — ostensibly to mop up black money. This ill-thought through, badly implemented monetary shock probably added to the decline by around one percentage point of the GDP so far and its full effects may linger on for another few quarters — especially if the tax inspector raj unleashed to look for black money is not reined in. A new goods and services tax law should have boosted the government's reformist credentials. But in the short term its complexity and complicated implementation arrangements will end up hurting the economy.

But the decline in GDP growth has deeper roots which must be addressed as well. Three policy issues are key to longer-term recovery.

The first is the Reserve Bank of India's (RBI) monetary policy framework, under inflation targeting, which this government accepted without fully understanding its implications. Inflation targeting implies that the RBI focuses on inflation first and growth second. But ironically in a developing country like India with food inflation at 40 per cent of the consumer price index (CPI) — over which the

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RBI has no control — an inflation targeting framework can be counter-productive. This is because if food prices rise due to a supply shock the CPI stays high and the RBI keeps interest rates high hurting growth even further.

Moreover, as we have seen recently, the RBI does not target current inflation but future expected inflation. The RBI has made huge forecast errors on inflation in the last three years and kept interest rates too high. As a result the real repo rate has gone from 50 basis points in 2014 to 600 basis points today. Real credit growth, which was averaging 18 per cent per year from 2011-14, has slumped to six per cent in 2017, resulting in declining investment and GDP growth.

The second is the overvalued exchange rate. With high interest rates, and a low risk of depreciation, portfolio inflows have increased sharply and led to an appreciation of the rupee by around 15-20 per cent since 2014. This huge real appreciation has hurt exports and encouraged imports, which in turn hurts domestic capacity utilisation, investment and growth. Exports, which averaged $26-$27 billion per month in 2011-2014, have slumped to $22-$23 billion from 2014-2017.

India must discourage short-term portfolio inflows both by reducing interest rates and other means, such as an Alternate Minimum Tax. One big signal would be to get rid of inflation targeting or at least make the setting of repo rates be less discretionary by requiring that they are tied to current, not future, forecast inflation. Banks should also have to automatically adjust lending rates to changes in the repo rate. Faster reserve accumulation will also further depreciate the rupee and correct over-valuation.

The third is a serious plan to resolve the twin balance sheet problem, which is holding back corporate investment and remains the biggest block to genuine recovery. The highly touted banking ordinance announced with much fanfare in May 2017 just kicks the can down the road, as it does not inject any new money for bank recapitalisation. The government is reportedly considering bank mergers. But without more aggressive resolution and recapitalisation just mergers will not solve the NPA problem. To finance the large sums needed for recapitalisation, the government needs to issue bonds.

An RBI bond as proposed in the Economic Survey will further damage an already weakened RBI. A domestic bond issue will soak up liquidity needed for new investment. One option is an international sovereign bond issue or getting the larger banks like State Bank of India to issue international bonds to recapitalise. A sovereign bond issue would increase external debt but it could be a cheap option given low international interest rates. A recapitalisation bond sold to the banks themselves could also be used but would it add to already high domestic debt, risking a downgrade by the ratings agencies.

More aggressive privatisation is another place to raise money: both to help finance public infrastructure investment, which will crowd in private investment and also to finance banking sector clean-up. Further deregulation of agricultural markets would also be a hugely positive step to help boost farm recovery — much more than farm loan waivers, which have further weakened already hurting state-level finances.

To win the 2019 election remember the famous slogan, "It's the economy stupid." That was what cost the UPA government the 2014 election.

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