Economy: Between a rock and a hard place

The euphoria over the tag of becoming, once again, the world's fastest-growing major economy should not lead to complacency. Just as the economy began recovering from self-inflicted policy mistakes, and began to grow rapidly again after a sharp slowdown in 2017, rising oil prices and trade protectionism threaten that recovery.

India benefited from good luck since 2014 when it received a huge terms of trade windfall — estimated by the International Monetary Fund to be around 2 per cent of GDP. Even though remittances fell from an average of 3.5 per cent of GDP in the period 2010-14 to an average of 2.5 per cent of GDP in 2015-16, the positive terms of trade helped rev up the economy to 9.2 per cent GDP growth in the last quarter of 2015-16 up from 6.2 per cent in the last quarter of 2014-15. But without serious reforms the economy started slowing down. Major policy mistakes — an ill-advised demonetisation and a poorly planned GST combined with very tight monetary policy brought the GDP growth rate down to 6.1 per cent by the first quarter of 2017-18 — despite favourable global conditions.

AJAY CHIBBER

Meanwhile, a banking mess was allowed to fester and grow. The government unveiled a series of half-hearted measures to address it and kept kicking the can down the road. Revealed non-performing assets (NPAs), at around ₹3 trillion when the BJP came to power, have grown to over ₹10 trillion. The right solution — taking out the bad loans into a restructuring agency along with serious reform of the public sector banks — is inevitable, although a bad bank will require massive external financing.

When oil prices fell from 2014 onwards the government kept two-thirds of the windfall — half to the central government and about a sixth to state governments. Only a third was passed down to consumers. Nevertheless, even this limited pass-through of lower oil and gas prices, and a stronger rupee helped lower inflation. But now, with oil prices rising the government has allowed much of the oil price change to pass on to consumers, to help secure its fiscal targets. But, combined with aweakening rupee, this will stoke inflation, forcing the Reserve Bank of India (RBI) to raise interest rates.

The RBI's policy stance was frozen since demonetisation. Had it lowered interest rates by about 100-150 basis points (bps) in 2017 it would have had the headroom to increase them now. From Q3 2016-17 to Q2 2017-18, i.e. during the first year of the Monetary Policy Committee (MPC), the real repo rate — RBI repo rate minus retail inflation — averaged over 300 bps.

Since then, rising inflation brought the real repo rate down to 140 bps in the last two quarters of 2017-18 — about where it needs to be. The most recent decision to raise the repo rate by 25 bps allows the real repo to remain at 140 bps. As inflation increases, the RBI will most likely raise rates again. With a negative terms of trade shock, the RBI should allow the correction in the real exchange rate, which appreciated in real terms by over 20 per cent since 2014, to continue. This will help boost exports, lower imports and contain the rise in the current account deficit (CAD), which could reach 2.5-3 per cent of GDP if oil prices remain high. The RBI must also use its reserves, built up over the last three years, to smoothen the fall in the rupee, as portfolio capital leaves India, and not tighten money supply too much, even as it must worry about rising interest rates in developed markets.

The room for manoeuvre on the fiscal front is also limited. The 10-year yield on government bonds is back where it was when the Modi government took power. The discipline in the central fiscal has been negated by rising state-level deficits. The lack of a bidder for Air India has also raised concerns over the disinvestment target.

The market clearly expects a tough fiscal situation with higher oil prices and rising interest rates. If the government absorbs some of the oil price shock and breaches the fiscal target it risks even higher bond yields. The poor shape of PSBs makes them unable to absorb more government paper at below market rates and their high NPAs are an additional source of concern for the markets.

Spending pressures will rise by the end of this fiscal year as we approach elections. No wonder the government has rejected the Niti Aayog proposal to sell off over 50 per cent stake in non-strategic public sector undertakings (PSUs). They may be the only source of funds available in the coming year. Oil PSUs will be asked to absorb some of the oil price increases – resulting in lower dividends eventually.

India must pray oil prices remain at around $70 per barrel, and Russia and Saudi Arabia increase production. A sharp drop in oil flows from Iran and Venezuela could send it shooting towards $100 per barrel and push the CAD over 3 per cent of GDP.

Overall, these factors do not augur well. India finds itself between a rock and a hard place. A smart, calibrated policy framework and careful coordination between the RBI and finance ministry are the needs of the hour, not populist "growth-enhancing" moves.

The writer is Chief Economic Advisor, FICCI and Distinguished Visiting Professor, NIPFP