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Outlook for the next six months

Three difficulties — global/local macro conditions, credit stress, and uncertainty — will weigh upon the January-June period, and result in relatively sombre outcomes

What can we expect of global/local macro conditions in the first half of 2019? We got a slow and partial recovery from 2012 to end-2018. But we now face headwinds again, through a combination of stress in the credit market and increased uncertainty. These problems may hamper output in the January-March and April-June quarters. This shapes the setting for macro policy, and determines the initial conditions for next Parliament and the Cabinet.

While the official GDP data has problems, we are able to reconstruct a measure of economic activity by combining other well-measured series. This portrays a slow and partial recovery from 2012 to 2018. What can we expect for January-June 2019?

The most important source of Indian macro fluctuations is private investment. Government investment is more stable and predictable. Private investment moves around quite a bit. The fluctuations of private investment, as seen in the firm data, are greater than those portrayed in the official GDP data. From 2011 onwards, private project announcements have halved in nominal terms. This has created stress in the macro-economy and in employment.

We must peer into the minds of private persons (both domestic or foreign) and wonder how to create conditions for high investment. We tend to view domestic investors as captive, but this is incorrect. Domestic investors always have the choice of doing nothing: If we want them to invest, we have to create conducive conditions. We should recognise the extent to which Indian persons are able to shift activities, assets and humans out of the country. We cannot take domestic investment for granted, just as we cannot take foreign investment for granted.

SNAKES & LADDERS

AJAY SHAH

Three concerns can be identified. The first lies in global and domestic growth. When the outlook for demand is buoyant, private persons are more inclined to invest. On the other hand, when demand is weak, the emphasis is on keeping up capacity utilisation and protecting production plans. Firms may even protect production by sacrificing margins, but then they would be reticent about adding capacity.

The second problem lies in credit stress in non-financial firms and in their lenders. About a third of the non-financial firm balance sheet is under credit stress as are about two-thirds of banks and non-banking financial companies (NBFCs). When one entity or a sub-industry gets into difficulties, it pulls back from lending to certain persons. In the short term, this generates stress for these borrowers, until new credit relationships are developed.

The difficulties in IL&FS, NBFCs, bond market and mutual funds have exerted ripple effects upon the real economy. These ripples propagate outwards from the site of the problem. A car company that sells/makes fewer cars becomes a car company that buys fewer automobile components, and so on.

The credit stress in the non-financial sector and in many lenders impacts the private sector's desire to invest and ability to invest. To some extent, difficulties of the credit market hamper economic activity, and thus take away the desire to invest for some firms. For some firms, the inability to borrow at attractive rates of interest hinders investment. It holds back the translation of a desire to invest in a full-blown corporate financial strategy that is required to back each investment project.

The third problem lies in uncertainty. Many individuals in the private sector are absorbed in dealing with investigative agencies. Investment requires optimism, and many persons may choose to put expansion on hold until the problems with agencies are solved. There are significant risks associated with dealing with regulators and taxmen. In the last few weeks, there is a focus upon waiting for the results of the general elections, after which various possibilities can be re-evaluated.

These three difficulties — global/local macro conditions, credit stress, and uncertainty — are holding back investment. These problems will weigh upon the January-June 2019 period, and result in relatively sombre outcomes.

This has implications for monetary policy. Monetary Policy Committee (MPC) members should reduce the importance they give to the official GDP data. Once this is done, we see a consistent picture of the economy where weak aggregate demand is giving low inflation. The RBI then has an obligation to help the economy get back to the 4 per cent CPI (consumer price index) inflation rate, the formal inflation target, by cutting rates. As the monetary policy transmission is weak, substantial cuts are required in order to have an impact upon the economy.

When the elections come close, and the RBI cuts rates, this would ordinarily be criticised as a political action aimed at supporting the incumbent. The beauty of the inflation target is that there is clarity about what the RBI has to do. We know that the CPI inflation rate has persistently stayed below the 4 per cent target, we have reasonable expectations of sombre conditions for January-June 2019, and this gives the justification for cutting rates significantly. The beauty of the inflation target is that cutting rates in January 2019 has become possible for the RBI, without accusations about electoral motives.

After the elections, the economic policy team will have to go to the root cause of these difficulties. The main organising principle that will help get the economy on track is: Create conditions for private investment. This will involve changing the behaviour of the state on how economic policy is formed, how regulators work, on tax policy and tax administration, and on investigation agencies. A good measure through which private investment can be tracked is the stock of private "announced" and "under implementation" projects, which is observed every quarter.

Political parties are now writing their manifestos. The priority in economic strategy design should be to get back to the construction of a market economy, with a light role for the government, where individuals and firms are protected by the rule of law. Such an economic policy strategy needs to be developed, and exhibited to the economy as was done in the July 1991 Budget speech. This will elicit respect, create business confidence and foster private investment.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi