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# Worry about the trend, not the cycle

## Our institutional capacity to support trend growth has not stayed the pace

SNAKES & LADDERS

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It is useful to decompose macroeconomic outcomes into long-term trends vs. short-term business cycle fluctuations. In the Indian story, there was a decline in trend growth in about 2011-12. Layered on top of this, we have had a decline in business cycle conditions. These two phenomena are playing out together today. The conventional tools of macroeconomic policy are feeble in India, in the best of times, and cannot make a difference to the decline in trend growth. The most important question in Indian economics is that of understanding, and reversing, the decline in trend growth.

Gross Domestic Product (GDP) measurement in India has many problems. We can learn a lot from firm data. The CMIE database now sees about 50,000 firms, and this portrays a good slice of the modern sector. We focus on the most important component of the economy, the private non-financial firms. There was a period of high trend growth from 1990-91 to 2011-12, and after that the trend growth rate went down.

Let's start at sales growth. For the period from 1990-91 to 2011-12, sales growth averaged 16.4 per cent (nominal) per year. In the following seven years, growth dropped to 10.5 per cent (nominal) per year. Turning to investment, the good measure is the percentage growth of net fixed assets. This had an average growth rate of 17.4 per cent (nominal) for the period from 1990-91 to 2011-12, and a lower growth rate of 10.3 per cent (nominal) in the following seven years. This is an important change in trend growth.

Layered on top of long-term trend growth is the phenomenon of business cycle fluctuations. These are short booms and busts, the perennial cycle of fluctuations of inventory-investment-profitability that blow through the firms. Our here-and-now problem is the decline in business cycle conditions that began in late 2018.

Business cycle fluctuations can be tamed to some extent through traditional tools of macroeconomic policy, i.e. fiscal and monetary policy. Many of us are brought up on international textbooks of macroeconomics, and we tend to jump to the conclusion that the tools of macro policy are available and effective in fighting business cycle fluctuations.

However, in the Indian situation, we should be more limited in our aspirations. In India, fiscal policy is not organised in a way that helps in stabilisation. With the emergence of inflation targeting in 2015, for the first time, monetary policy has started becoming useful in business cycle stabilisation. When the Reserve Bank of India (RBI) pursues the objective of a 4 per cent CPI (consumer price index) inflation rate, this will, in and of itself, generate increases and decreases of the policy rate in a way that counteracts business cycle fluctuations. At the same time, we have an underdeveloped financial system, so the RBI's potency is limited.

We should do inflation-targeting right, but we should know that its potency in India is limited, and we should know that fiscal policy in India is not participating in macroeconomic stabilisation. As a consequence, stabilisation through macro policy, as it happens in textbooks, does not particularly happen in India. We need not despair. The nice thing about every business cycle downturn is that left to itself, it will heal. The long history of business cycle fluctuations in India is reassuring in this respect; downturns of the past healed even though macro policy was ineffective and confused.

The bigger problem that we should worry about is the decline in trend growth. The most important question in Indian economics is: Why did we get high trend growth from 1990 to 2011? Why did trend growth go down after 2011? To the extent that we are able to understand this problem, and change course based on a sound intellectual understanding, this could be rather important.

In this, we should resist simplistic notions of cause and effect. There is the danger of giving credit to the July 1991 Budget speech for the boom that began in 1990-91, and there is the danger of burdening Pranab Mukherjee for the end of this boom in 2011-12. But social phenomena of this scale resist simple explanations. Changes in trend growth come about through the cumulation of historical forces and human actions over many years.

The foundations of the 1991-2011 boom were laid, in many ways, from the change in course of economic policy, away from Indian socialism, which began in 1977, when the Janata Party took charge. A large number of actions took place from 1977 to 1991, and the July 1991 Budget speech was the final trigger for the dramatic change in trend growth.

In similar fashion, the end of this growth episode did not happen through actions in 2011-12. Once Indian GDP enlarged greatly, the institutions were inadequate in dealing with a bigger and more complex economy. A sophisticated private economy requires capabilities in the criminal justice system, dispute resolution, the judiciary, economic regulation, and the tax system. It requires an ethos of public policy that is defined around economic freedom and political freedom. However, we limped to a $2-trillion GDP in 2014, holding an institutional capacity that was frankly designed for the $0.2 trillion GDP of 1982.

Over the years, the mismatch between the requirements of the private sector versus the capabilities of the institutions got steadily worse. This growing mismatch added up to the demise of that growth episode in 2011-12.

There was a tension between hope and experience in the eyes of private persons through this growth episode. There were many, many infirmities in the working of the institutions in that period. Private persons were, however, willing to suspend their disbelief, and were caught up with the idea that while things are bad today, they are moving in the right direction, and occasionally when the government springs a disaster, there will be recourse and problems will be solved. This package of beliefs added up to the decision to commit to India, to build a business in India, to invest financial capital in India. What changed by 2011-12 was the loss of this optimism.

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