LEAD

Key steps to kick-starting the economy

C. Rangarajan

DECEMBER 25, 2019 00:02 IST
UPDATED: DECEMBER 25, 2019 00:45 IST

Getting financial institutions to a healthy state when they can begin to lend confidently is most crucial for faster growth

We bid goodbye to 2019 with a sigh of relief. Anything that could go wrong went wrong during this year. Growth rate plummeted. From the level of 8.1% in the fourth quarter of 2017-18, quarterly GDP growth fell to 4.5% in the second quarter of 2019-20, a fall of 3.6 percentage points. This steady decline must have had an adverse impact on employment and poverty reduction. Will 2020 be better? What can be done to make it better?

Structural or cyclical

Analysts debate whether the slowdown is structural or cyclical. Does the difference matter? Yes, to some extent. If it is cyclical, the expectation is that there is a chance for upturn soon. If it is purely structural, it will take time until the structural rigidities are removed.

Normally, the slowdown is cyclical if it results from a weakening of demand. There is plenty of evidence on this as far as the current situation is considered.

Several important sectors such as automobiles, consumer durables and housing (on which data are available with high frequency) do show a slackening of demand. This is also reflected in the low capacity utilisation of several industries.

On the structural side while the reform agenda has been carried forward, there are segments such as agricultural marketing, land and labour markets which are still waiting for reforms.

One sector which needs immediate reforms is the financial system — more particularly the banking system and within it the public sector segment. Even as the policy makers address the problem of non-performing assets, attention has to be paid to defining the relationship between governments and boards of public sector banks and on their respective roles in management.

Whether we call it a structural problem or not, one significant factor in the current scene is the steep fall in investment rate (gross fixed capital formation rate) from 34.3% in 2011-12 to 27.8% in the second quarter of 2019-20. This results in a sharp decline in the potential rate of growth by 1.6 percentage points, assuming an incremental capital-output ratio of 4.

Channels of demand

When we address the issue of demand, we need to look at the four-five expenditure categories of national income accounts: private final consumption expenditure, government final consumption expenditure, gross fixed capital formation private and public, and exports. Data definitely show a weakening of private consumption expenditure. But in our efforts to raise demand, it is not autonomous. It is dependent on income.

Therefore, the three autonomous elements that can be used as levers to raise demand are government consumption expenditure, government investment and exports. Private investment can be treated as autonomous only to a limited extent. However, private foreign investment can be an independent factor which can be leveraged.

Exports can help to stimulate the economy since exports are influenced by the state of the economy in the rest of the world. Unfortunately, in the current situation, the rest of the world is also not booming. However, an effort can still be made to get a better export performance. This leaves us only with raising government expenditure. This is indeed the standard prescription whenever there is deficient demand.

However in the present context, the emphasis should be to ensure that the entire increase in government expenditure is diverted towards capital expenditure. The old dictum of “digging holes and filling them up again” will not do. But the critical question is this: is there is any scope for increasing expenditure? What then are the actions that can be taken to stimulate the economy?

Monetary policy

Monetary policy has done its role by reducing the Repo rate by 135 percentage points since February 2019 to date. Banks have not followed suit fully due to the high level of non-performing assets. While the Reserve Bank of India (RBI) can play a supportive role in expanding liquidity, we must understand the limitations.

Monetary policy generally is more effective in controlling inflation than stimulating an economy. In the present context of the banking situation, the RBI’s role that is even more important than pure monetary policy will be to quicken the resolution process of bad loans and help banks to move to a more healthy situation. The task is not that easy.

Fiscal policy

The counter-cyclical fiscal policy is also running into problems. Given the revenue trend, the Central Government may not find it easy to increase its capital expenditures relative to GDP.

In this context, one critical question that is under debate is whether the present situation warrants a breach in fiscal deficit norms. It may be recalled that against the background of the international financial crisis of 2008, the fiscal deficit of the Government of India was raised to 6.0% in 2008-09 and it went up to 6.5% in 2009-10.

While this extraordinary increase led to the growth rate rising immediately, it landed us in problems later on. However, a modest breach in fiscal deficit may be acceptable. This is not to ignore the concern that the fiscal deficit indicated by the Budget is always lower than the “true” or “actual” fiscal deficit. That problem might still continue.

A focused increase in capital expenditures of the Government and the Central public sector undertakings (PSUs) may help to apply the brakes on the slowdown. It might also help to "crowd in" private investment.

Reform of the Goods and Services Tax (GST) is very much needed. We need a relook at the commodities falling under various slabs. Perhaps in an effort to get the GST through, a lot more of commodities were pushed under the lower slabs. Detailed data on GST collections are not available in the public domain to be able to take a view on this. Reforms in this direction may perhaps have to wait till the economy turns around. The GST has to become more manufacturer and trader friendly.

Banking situation

The present economic situation, in a sense, has become more complicated because of the poor health of the financial system. An excessive expansion of credit in the earlier years combined with the slowdown have contributed to a rise in non-performing loans in the banking system. Had the banking system been healthy, it could have been used as a lever for stimulating the economy. On the other hand, the banking system, currently, has become a burden. Quickening of the resolution process along with the recapitalisation of public sector banks has to take priority. The cleansing of the financial system which also includes finding solutions to the problems of non-banking financial companies will help to push the economy up. In a sense, this is our "2008-09 crisis".

It is not much solace to say that 2020 will be better than 2019. The reasonably good monsoon may lead to an improvement in agricultural production and rural demand. Exports can help a bit if there is strong effort and if the global trade environment improves. Increased government expenditure, particularly in capital expenditures, is one intervention which is very much needed. Private investment can pick up provided the growth rate begins to look up. Restoring financial institutions — banking and non-banking — to a healthy state when they can begin to lend confidently is the most essential prerequisite for faster growth.

C. Rangarajan is Former Chairman of the Economic Advisory Council to the Prime Minister and Former Governor, Reserve Bank of India

Printable version | Dec 25, 2019 9:47:50 AM | https://www.thehindu.com/opinion/lead/key-steps-to-kick-starting-the-economy/article30391156.ece