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Three Years of Narendra Modi's Government – An Assessment on the Economic Front

In the three years it has been in office, the Narendra Modi government has notched up notable accomplishments, especially in improving the investment climate and deepening financial inclusion. At the same time, it has disappointed on the jobs front and in establishing a clear policy line on public sector banks. The government's bold decision on demonetisation was controversial and it is too early to say whether it has been a success. The jury is still out also on whether the government has got its act together on improving governance. Finally, the ruling party has to decide whether it will pursue the economic agenda with undivided attention or whether it will also simultaneously further its social agenda.

Duvvuri Subbarao[1]

India's macroeconomic situation has decidedly improved since the Modi government came into office three years ago. Growth is on the uptrend, save for the hiccup caused by demonetisation, inflation has declined, the rupee is steady, the current account deficit is well within the Reserve Bank of India's (RBI) comfort zone and the central government has remained committed to fiscal responsibility.

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Macroeconomic Situation – A Comparative Perspective

As per the figures put out by the Indian Ministry of Finance, the comparative picture is as follows:

	2011/12-2013/14 Three year average	**2014/15-2015/16 Two year average**	**2016/17**
GDP Growth (%)	6.0	7.6	7.1
Inflation (CPI) (%)	9.8	5.4	4.6
Current Account Deficit (% of GDP)	3.6	1.2	0.7
Foreign Exchange Reserves (US$ billion)	297	351	363
Net Foreign Direct Investment (US$ billion)	21.1	33.6	21.3
Fiscal Deficit (% of GDP)	5.1	4.0	3.5

Source: Key Achievements of Department of Economic Affairs, Press Information Bureau, Government of India, 22 May 2017; http://dea.gov.in/sites/default/files/DEA%20Key%20Initiatives052017%20.pdf

It is tempting to attribute this improvement in the macroeconomic situation to the Modi government. That will be misleading. To see this in perspective, we need to ask the counterfactual question. Would the macro situation have been much different had the United Progressive Alliance (UPA) government returned for a third term? It will be fair to conjecture that it would have been the same except maybe some changes at the margin. Here is why.

Economic growth in India over the last three years was driven largely by private consumption which is robust because of the affirmative action programmes of the UPA government such as the employment guarantee scheme. Inflation is down mainly on account of the decline in the global crude price, although the National Democratic Alliance (NDA) government deserves to be commended for its efficient food distribution which has kept food prices in check. The current account decline owes to the improvement in the global situation and the improvement in public finances began in the last two years of the UPA government. Arguably, India would have been the fastest growing large economy in the world irrespective of the change in government.

Indeed, the Modi government deserves credit not so much for the improvement in the macroeconomic situation over the last three years but for laying the foundations for strong and sustainable growth in the years ahead. In that context, this essay will highlight two areas where the government has accomplished definite results, two areas where it has disappointed and two areas where judgement has to be reserved until outcomes become clearer on the way forward.

Improvement in Investment Climate – Several Big Steps Forward

The first big accomplishment of the government lies in the slew of reforms it has instituted to improve the investment climate. It institutionalised a new monetary policy framework, substantially liberalised the foreign direct investment regime, enacted the insolvency and bankruptcy code, accelerated road and other infrastructure construction, and most notably negotiated the Goods and Services Tax (GST) through the complex web of India's fiscal federalism. Arguably, these are not original ideas nor were they entirely virgin policy areas; a lot of groundwork was already done. Even so, the NDA government deserves credit for resolutely implementing all these reforms. These would help crowd in private investment once the balance sheet health of the Indian corporate sector is restored.

Financial Inclusion – A Concerted Drive

The second big accomplishment of the government is the concerted drive for financial inclusion, which has the potential to be transformative. This again is not a new initiative; it has been around for over a decade. Where the Modi government has made a big difference is by way of the commitment and diligence with which financial inclusion has been pursued through what the government calls the JAM pillars – J standing for *Jan Dhan Yojana* which aims to cover all low income households with bank accounts and to give them access to medical and life insurance products tailored specifically for low income households; A standing for *Aadhar*, the universal identification number, particularly valuable to low income households to establish their identity; and M standing for mobile phones, the main instrumentality for facilitating payments. In less than three years, a staggering 280 million bank accounts have been opened, 220 million RuPay debit cards have been issued and an unprecedented two-thirds of the accounts have been seeded with *Aadhar* to enable direct benefit transfer (transfer of government subsidies directly to the bank accounts of the beneficiaries).

A standard problem with the pursuit of financial inclusion in the past has been that even as bank accounts were opened for low income households, they remained dormant. Recent empirical studies show that a preponderant portion of the accounts are now actively being used. The government has also established the Micro Units Development and Refinance Agency, a new development finance institution to provide credit for micro and small enterprises. Finally, the RBI has licenced small finance and payment banks. They will help deepen the penetration of the formal financial sector into the hinterland of the country.

Job Creation – A Big Disappointment

Now coming to disappointments! The biggest failure of the Modi government is on the jobs front. Modi campaigned on a platform of providing gainful employment to the youth; and presumably his landslide victory in 2014 owes to the faith hundreds of millions of youth reposed in him. Recent data put out by the country's Labour Bureau paint a disappointing picture. Employment generation in the organised sector over the last two years has fallen to less than a quarter of the peak rate reached in the high growth years of 2009-11. The government claims that job creation in the unorganised sector is quite vigorous but this is unconvincing, given the strong historical correlation between jobs in the organised and unorganised sectors.

It is now fashionable to talk of India's unique demographic dividend, especially in the context of population sizes stagnating or even falling in the rich countries. However, a necessary condition for realising the demographic dividend is to create jobs so that the virtuous earning-saving-investment cycle can take off. That condition is far from being fulfilled, making demographic dividend a distant prospect.

Where are the jobs going to come from? Not from the agriculture sector. Indeed, the agriculture sector, as is well known, is a repository of huge underemployment and will throw out hundreds of millions of people if agricultural productivity goes up as indeed we want it to. The unorganised services sector cannot create productive jobs on the scale required. The large manufacturing sector, given its inherent bias against labour and in favour of capital, does not hold out much hope either.

As such, the main source of large scale job creation has to be the small and medium enterprises (SME). Admittedly, the government has expanded and extended support to the SME sector in many ways, for example, by reducing the corporate tax levied on them. However, these initiatives have been sporadic, piecemeal and disparate.

What is disappointing is that the government has not so far come out with a comprehensive plan for attacking the most basic problem in the country – unemployment. Among the many challenges in addressing the unemployment problem is the lack of reliable data. The government has recently constituted a committee to study the unemployment statistics and advise it on improving data capture and analysis. The committee's recommendations will hopefully form the basis for the government to formulate a time bound action plan for employment generation and enable the government to show not just resolve but even results well before the next general election due in mid-2019.

Public Sector Banks – Quo Vadis?

The second big disappointment with the government has to do with the lack of clarity on how it plans to recapitalise public sector banks which are staring at a huge capital gap because of the burden of bad debt. Restoring the health of Indian banks, more particularly the public sector banks, is critical to returning the economy to a strong and sustainable growth path.

The genesis of this challenge lies in what has come to be called India's twin balance sheet problem – banks unable or unwilling to lend because of accumulated bad debts, and corporates, the potential investors, unable or unwilling to borrow because of overleveraged balance sheets – which has now reached crisis proportions. To break the logjam, the government has recently amended the Banking Regulation Act to vest the RBI with extraordinary powers.

How quickly and how effectively the bad debt problem is resolved is as yet uncertain. What is clear though is that the resolution of bad debts is, in fact, the first of a two-step challenge. To clean their loan books, banks will be required to recognise substantial losses which will erode their capital base. They can get back into the business of lending to kick-start the investment cycle only if they are recapitalised. It is difficult to put a figure on the capital gap that would arise consequent to the bad debt resolution but it is likely to be substantial. The recapitalisation requirement will come on top of the additional capital that banks are obliged to bring by March 2019 to meet the Basel III[2] norms.

The recapitalisation challenge raises a number of big ticket policy issues. How will the government meet its share of the recapitalisation burden given its obligations under fiscal responsibility? Will the government consider some financial engineering options to meet the recapitalisation burden whereby it can raise money from the market without giving up its controlling stake in the public sector banks? What is the likelihood that it might succeed in such endeavours? Will the watchdogs, particularly the rating agencies, not penalise the government, viewing such financial engineering as a contingent fiscal liability or even as in infringement of fiscal responsibility?

The Modi government needs to come out with a comprehensive and credible plan to reassure potential investors that it is ready to manage what is going to be a big policy challenge.

Demonetisation – Cost-benefit Calculus

Finally to the two issues on which judgement has to be reserved in view of insufficient evidence as yet to make an informed evaluation.

The first of these is the *blitzkrieg* demonetisation of high denomination currency effected by the government in November 2016. The decision was hailed by some as a bold and decisive move to hit at black money which is eating into the vitals of the economy, and panned by some as hasty and ill-advised with huge costs and uncertain benefits. During the period of currency ban which ran for nearly two months, both the government and the central bank were pilloried for the lack of prior preparation and for the ham handed implementation of the scheme.

2 'Basel III' is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and strengthen banks' transparency and disclosures. See http://www.bis.org/bcbs/basel3.htm. Accessed on 9 June 2017.

Now that all that is history, a provisional assessment is in order. On the cost side, it is clear that hundreds of millions of people in the informal sector suffered pain and hardship, with many even losing their livelihood. Recent data put out by the government's Central Statistical Organisation suggest that the loss of economic growth on account demonetisation is as much as a percentage point.

On the positive side, the results are not yet clear. In course of time, the benefits, if any, because of demonetisation should show up in two ways. First, by way of a sustainable step increase in the tax-GDP ratio; and second, by way of higher growth consequent on decline in corruption, shift in savings from physical to financial, minimisation, if not elimination, of fake currency and transition to a digital economy. The jury is still out.

Improving Governance – The Big Elephant in the Room

The second issue on which judgement has to be reserved is on improving governance. There is any amount of evidence to show that investment in India is frustrated by poor governance – a labyrinth of vexatious procedures, an irresponsive, insensitive and often venal bureaucracy and deeply entrenched corruption. The Modi government deserves to be commended for not only acknowledging the need to improve governance but for also according it high priority – in particular, for setting a target of moving India into the top 50 countries in the World Bank's ranking of countries by way of 'ease of doing business'. The government has moved in the direction of streamlining procedures, making the bureaucracy accountable for results and hitting at corruption.

However, there is only so much that can be done from Delhi. Much of the action lies in India's 29 states which are on the frontlines of governance. Many investors complain that what vexes them is not so much getting permits and clearances from the governments in Delhi or state capitals but getting things done at the field level. A heartening development in India over the last decade has been increasing competition among states for investment, driven by a growing realisation among state-level politicians that their electoral prospects depend on creating jobs and the key to creating jobs is to attract investment. This competition, in turn, has the potential to trigger governance improvements at the cutting edge level.

Modi, having been chief minister himself for over a decade, and a successful one at that, should be aware of the limitations of the central government and the need to enlist the cooperation of states in a collective endeavour to improve governance across the country. A good starting point will be a meeting with all chief ministers to discuss a national agenda and action plan for improving governance.

Economics and Politics – Critical Choice

At the end of three years, the Modi government's record is a mixed one. It has notched up notable accomplishments, has disappointed in some important areas and has moved forward on a wide canvas which is 'work in progress'. As it enters the final lap of its five-year term, the government faces a formidable agenda – implementing the GST, resolving the bad debt problem, recapitalising banks, improving governance and generating jobs.

Admittedly, politics is not just governance and macroeconomic management. The ruling party has a huge social agenda that leaves the party leadership with an important decision to make, particularly in the light of its recent successes in elections to state assemblies: how far should the social agenda be allowed to displace or eclipse economic goals and priorities in the run-up to the 2019 elections? If the party leadership avoids confronting this question for long, it may discover that events determine their own journey and destination. That will be decidedly sub-optimal.

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