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India's Current Macroeconomic Situation

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The Narendra Modi Government in India has inherited a very challenging macroeconomic situation.

Growth

2. Output growth has moderated significantly. Growth was 4.5% in fiscal year 2012-13 and 4.7% in fiscal year 2013-14. This is the first time in 25 years that growth has slipped below 5% in two consecutive years. This growth record is a sharp contrast from India's remarkable growth performance in the pre-crisis period when the economy clocked average annual growth of 9.5% + in the period 2005-08.

3. It is common for Indian policy makers to attribute all of this growth moderation to external factors, especially the impact of the global financial crisis. Self-serving as it might

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be, this assertion is both wrong and potentially misleading from a policy correction perspective. Even in the crisis year of 2008-09, growth dropped only to 6.7%, and in the two years after that, growth recovered almost to the pre-crisis rates. This evidence suggests that India's growth moderation is almost entirely due to domestic factors, notably the 'policy paralysis', and more importantly, 'policy implementation paralysis' of the previous government.

Inflation

4. Inflation in India has been high and stubborn. Although it has come off from the near-double-digit peaks of 2010 and 2011, at above 8%, it is still quite high. Inflation is a problem everywhere, but can be particularly painful in a country with poverty levels as high as 30%.

5. The problem is that India's inflation is structural which implies that it will not let up unless systemic reforms are undertaken to ease the supply constraints.

6. The main factors driving inflation are the following:

(i) Food: One of the remarkable, but less recognised and even less acknowledged, socio-economic developments of the Indian economy over the past decade has been the rise in rural incomes brought about by affirmative action programmes, the Mahatma Gandhi National Rural Employment Guarantee Programme (MGNREGP) and the rising minimum support prices offered for major grains (rice and wheat). An important consequence of this rural uplift has been the shift in the dietary habits of the rural poor from cereal to protein. In this sense, at least a part of India's inflation is a problem of success. Even as demand for protein food has been rising, the supply has not kept pace because of the flawed agricultural procurement and pricing policies of the Government which discourage farmers from shifting from cereal production to protein production. The absence of an efficient supply chain from the production to the consumption centres is also a factor inhibiting production of protein foods.

(ii) Fuel: The second major driver of India's inflation is the global price of commodities, especially of crude oil. India imports 80% of its oil requirement and its domestic prices are extremely vulnerable to global oil prices. The problem is exacerbated by fuel subsidies (on diesel, cooking gas, and kerosene) whereby the Government absorbs most of the higher cost. The demand response that might come about if people have to pay higher prices (when they will reduce consumption) is thus forfeited.

(iii) Supply constraints: The supply constraints, especially in infrastructure, raise the costs of business in India and add to inflationary pressures.

(iv) Demand pressures: Contrary to popular perception that India's inflation is entirely owing to supply constraints; demand pressures play an important role in fuelling inflation. In an economy with a per capita income of less than US$ 1,500 per year, any increase in income quickly translates into increase in consumption; this phenomenon has been playing out prominently in India as a result of the rise in rural incomes.

Balance of Payments

7. The Indian rupee came under enormous pressure last year after the announcement by the US Fed of the impending 'tapering' of their Quantitative Easing (QE) measures. The exchange rate became quite volatile and the rupee depreciated by as much as 25%.

8. The situation has since stabilised because of some fire-fighting measures by both the Government and the Reserve Bank of India. The rupee has remained fairly steady over the last few months even in the face of actual tapering (of the 'fragile five', the Indian rupee came out much ahead in the last few months). The Current Account Deficit (CAD) too has declined significantly largely due to the draconian import control measures on gold imports

9. Notwithstanding this recent respite, India's balance of payments remains vulnerable. Its manufactured exports are at the low-end of the value chain, and the competitiveness of its software exports is threatened by rivals such as the Philippines, Sri Lanka and even China, which are all competing for a share of the global business. The weak rupee, contrary to expectation, has not improved the competiveness of India's exports in any marked sense.

Indian exporters are largely price takers in the global markets, and any advantage an Indian seller might have is arbitraged away by the foreign buyer. There is conclusive evidence that India's exports are more income-sensitive than price-sensitive. Even as the prospects for a marked increase in India's exports are not promising, at any rate in the short-term, its imports will rise for a number of reasons. If growth picks up, non-oil and non-gold imports will rise. Gold imports will pick up if the restraints imposed last year are relaxed, as they will have to be. The oil import bill will go up as oil prices are likely to firm up because of growth-recovery in rich countries and the turmoil in Iraq and Syria. For all these reasons, the Current Account Deficit on India's BoP will remain under pressure.

10. On the Capital Account side, there have been significant inflows in the last few months, large enough, in fact, to put an upward pressure on the rupee. But much of these flows are fickle as they are due to: (i) liquidity in the global system because of Quantitative Easing by rich economies; and (ii) confidence that India's new government will revive the economy quickly and improve the promise of returns on the invested capital. For the same reasons, this capital could exit abruptly if: (i) advanced economies raise interest rates, thereby signalling recovery; and/or (ii) confidence in the Modi Government of delivering quick results evaporates, a likely possibility given that expectations are super-charged and positive results will inevitably take time to materialise.

11. In sum, although there is some respite on the BoP front, it cannot be sustained in the absence of credible reforms being unveiled fairly quickly.

Policy Priorities

12. Mr Modi's campaign platform was economic recovery, showing off Gujarat as an example of what can and should be achieved at the national level. He consciously made it a point to de-emphasise the '*Hindutva*' dimension of his Bharatiya Janata Party, in order to give an undiluted focus to his economic platform. It should also be noted that the vote against the previous United Progressive Alliance Government was also a vote against high inflation. In sum, the mandate that Mr Modi got was almost entirely owing to the confidence that he will be able to revive economic growth and rein in inflation. Any failure to meet the expectations in this regard will seriously dent the Government's credibility.

13. The problem, though, is that neither of these – reviving growth or restraining inflation – can be achieved in short order. By their very nature, they will take time. They require tough political decisions and decisive implementation through improved governance – areas where the previous Government failed.

14. Ironically, the most important thing to do for both growth-revival and bringing inflation down is to revive investment. This requires reviving stalled projects and bringing fresh investment, especially into infrastructure. Some of the priorities in this regard:

(i) Streamlining land acquisition
(ii) Coal supply linkage to power sector
(iii) Labour Market Reforms
(iv) Open up some critical sectors like insurance to larger foreign investment
(v) Accelerating disinvestment
(vi) Legislate and implement Goods and Services Tax (GST)

Drought

15. An immediate and admittedly complex challenge for the Modi Government would be to make contingency plans, on both administrative and financial fronts, for a possible drought later this year.

16. The Meteorology Department has predicted monsoon rainfall of 90% of long-period average. If previous experience regarding prediction vis a vis outcome is any guide, the actual rainfall may be much poorer. The extent of distress will depend also on the spatial and temporal distribution of rainfall. The problem will be not so much in cereals (because the Government has buffer stocks which can be released into the market) but in oilseeds and pulses (legumes) which are grown in mainly rain-fed areas (poorer states or provinces). Imports in short-order will be difficult.

17. A potential drought will add to Government's fiscal pressures, as it will result in lower revenues (because of lower growth) and higher public expenditure (towards drought relief), making fiscal consolidation that much more challenging. How the Government will manage the imperative of fiscal consolidation, in the face of pressure to spend on drought

relief, will be watched by analysts and investors around the world to gauge the Government's commitment to fiscal consolidation in particular, but also for its reform credentials in general.

18. The Government has two options. The first is to present a budget on 'business as usual' basis saying that it will make an adjustment down the line, as may be necessary, for lower revenues and higher expenditure on account of any drought. This will not only erode the credibility of the budget, but also open up the Government to criticism of being irresponsible in not making any contingency planning for drought. On the other hand, the Government can provide for drought relief, and say that because of that contingency, it is 'pausing' for one year on fiscal consolidation. This will be politically costly as the previous government had taken enormous credit for its fiscal consolidation in very challenging political circumstances, and this Government will be seen as not measuring up to that challenge. Many investors and analysts, especially foreign ones, may also interpret any let-up in fiscal consolidation as poor commitment to much-needed reforms.

19. The Finance Minister is thus caught between a rock (planning and providing for drought) and a hard place (fiscal consolidation), and how he will negotiate this balance needs to be watched.

20. Incidentally the Government is alive to the possibility of drought and has taken some advance action already: (i) Release of 5 million tons of rice from the buffer stock to the market via the states; (ii) Advice to the states to de-notify fruits and vegetables from the Agricultural Produce Marketing Committee (APMC) Act, thereby freeing up the sale of these products in the open market; (iii) A line of credit to the states to import oilseeds and pulses.

Medium-Term Outlook

21. India's remarkable growth of 9+% in the pre-crisis years had triggered aspirations that India too, like China, can clock sustained high growth over an extended period. These aspirations have since become subdued on the back of India's recent poor, if not distressing, economic performance – low and moderating growth, and high and stubborn inflation. In fact there are widespread concerns that India may have forever got derailed from the high growth trajectory. Even the most optimistic now put medium-term growth rate at 8%.

22. Notwithstanding these concerns, it is worth noting that the long-term growth drivers of India – demographic dividend, a large and growing middle class, high savings rate, get-up-and-go spirit of entrepreneurism, untapped administrative capacity – are all intact. The challenge and opportunity for the Modi Government will lie in harnessing these growth drivers through effective policies and good governance.

23. But high growth is not inevitable. In the absence of decisive reforms, effective governance and strong and honest leadership, these opportunities can easily be squandered away. That will be an enormously costly proposition for a country that houses more poor people than the entire continent of Africa.

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