Rays Of Hope For Economy

Recent policy activity – like on retail FDI – promises that government is getting back to business

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It is the beginning of a new year. Low growth, persistent high inflation and policy paralysis have been the dominant themes of the past year. Fortunately, thanks to recent enabling changes in the political arithmetic of Parliament, in particular the marginalisation of Mamata Banerjee, we are beginning to see the first signs of an economic turnaround.

Everybody is bullish on India in the long term. Our large, young population is our greatest asset. Over the next three decades it will help drive down the dependency ratio and push up the rate of growth. But for this rosy scenario to be realised, we need to adequately educate and skill our young workforce, and invest in enough infrastructure, plant and machinery to employ them productively. These long-term policy priorities are quite clear. The challenge is to successfully navigate our way around the short-term barriers and stay focussed on the long-term priorities for high growth.

On the external front, the immediate danger is the US fiscal cliff. Political brinkmanship has taken us right to the edge. If the US economy were to go over that edge, it could bring the whole global economy crashing down. Somehow i don't think that will happen. Nor do the markets it seems; so far there is no panic. In the end, the Democrats and Republicans are likely to come to some deal. Despite that, recovery in the US is likely to remain slow.

The bigger worry is Europe. There is broad recognition now that the austerity mantra has not worked. Much of Europe is in recession and unlikely to come out of it any time soon. These negative factors are largely responsible for the slow growth of Indian exports, and a yawning current account deficit that is now approaching 4% of GDP. This is not sustainable.

Fortunately, there are also some positive developments. The new Shinzo Abe government in Japan is likely to make a strong move towards pump-priming Japanese growth. More important, the rebalancing of the Chinese economy towards greater dependence on domestic demand is creating significant export opportunities for other emerging market economies, including India.

> Sooner rather than later, the underlying bullishness on India will re-emerge and the country return to the long-term path of high growth

The Indian rupee has depreciated by around 50% against the Chinese renminbi over the past five years. During this period, India's manufacturing exports have grown faster than that of China according to some estimates. If this trend persists, the current account deficit should hopefully come down to sustainable levels during the next year or two despite the weak state of demand in Europe and the US.

Confidence is getting restored, as stock markets show

At home, high inflation persists along with low growth. Wholesale price inflation of over 7% is way above the RBI's comfort level, and consumer prices have been rising at double-digit levels for nearly three years now. I cannot recall any other period in the recent past when this has happened. Ten per cent was considered the Lakshman rekha for inflation tolerance in India. Once it was crossed, there would be protests and demonstrations across the country.

That has changed. Protests against price rise have had little political traction this time. How come? We are probably in a wage-price spiral now. Money wage increases seem to be keeping pace with price increases even in the unorganised sector, where workers are the lowest paid and usually the worst affected by inflation. Such data that we have on wage movements suggests this.

The RBI has deployed all the tools it has to bring down inflation, but high inflation has persisted. That makes it difficult to lower policy interest rates to stimulate growth, especially if the fiscal deficit remains above the target. Finance minister P Chidambaram's stated aim is to contain the central government fiscal deficit for the current financial year at 5.3% of GDP, as compared to the budget target of 3.1%, but most analysts are anticipating a deficit of around 5.75%. There is limited room to make up the revenue shortfall in the remaining three months of the year.

The main initiatives for fiscal consolidation are likely to feature in the forthcoming budget for the next fiscal. Those initiatives will be critical for the resumption of high growth. The principal factor that has led to the recent decline in investment and growth is the loss of investor confidence arising from policy paralysis during the past two years. That scenario is now changing. Chidambaram's early moves on the tax policy side, setting aside GAAR and re-interpretation of tax laws with retroactive application, have been followed by the recent flurry of policy activity on FDI in multi-brand retail, new bank licensing and the land acquisition Bill. There may be infirmities in the details of the new policies, but the overarching message is loud and clear. The government is getting back to business. This is beginning to restore confidence, as is already evident in the stock market. This process now needs to be reinforced with a strong programme of fiscal consolidation.

It will be some time before the turnaround is fully established. However, sooner rather than later the underlying bullishness on India is likely to re-emerge and the country will be back on the long-term path of high growth. That should be the high note on which we start the New Year.

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