Watching The Economy

To rebound in 2012, India must address domestic challenges and face off global crisis

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As we approach the end of another year, the economy is being buffeted by multiple challenges on several fronts. While some of these problems are of our own making, there are others beyond our control.

On the growth front, even optimistic official forecasters, who were earlier predicting a growth rate of over 8.5%, are now admitting that growth will be only around 7%. The latest monthly index of industrial production indicates that growth in the industrial sector has actually turned negative. The slowdown was expected, the expected collateral damage arising from monetary tightening and rising interest rates aimed at curbing inflation. Incidentally, there have been many complaints that the central government will overshoot its deficit target, which indeed it will. But had it succeeded in meeting the deficit target, growth would have been even lower.

Unfortunately, while the high interest rate policy has curbed growth it has failed to contain inflation. Inflation has persisted at around 9% for over two years now, even though the RBI continued to raise the repo rate that drives other interest rates. However, this instrument is effective when inflation occurs due to excessive demand, not when it is driven by cost-push factors, as in the present episode of inflation. During much of 2010, high inflation was being driven by rapidly rising food prices resulting from low growth in domestic food production. During the current year, however, the cost push has come mainly from rising commodity prices abroad: fuels, metals and food prices have all risen quite sharply this year. Under such conditions of imported inflation, interest rate hikes are not very effective in containing inflation.

The RBI has now announced a pause in its policy rate hikes, anticipating a reduction in inflationary pressures. This is quite likely. Domestic food price inflation has declined quite sharply, and so has inflation of global commodity prices. Normally, this should lead to a significant reduction in the headline inflation rate. Unfortunately, much of the benefit of this moderation in global commodity price increases has been offset by rupee depreciation, since this again translates into a rise in the rupee price of imports, which then spreads to other products.

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The rupee's depreciation by around 15% in recent months, while aggravated by domestic speculative activity, is primarily traceable to the ongoing sovereign debt crisis in Europe. As observed during the crisis of 2008, the present crisis has again led to a large withdrawal of FII money from the Indian stock market, eroding its value by as much as 20%. This large withdrawal of portfolio investments from India has led to the depreciation of the rupee.

Is ours a bankable growth story?

The outlook for the Indian economy, as indeed for the world economy, depends in large measure on how the sovereign debt crisis in Europe plays out in 2012. The EU summit earlier this month, the latest of many, marked some significant achievements. To help stabilise stressed EU economies, EU countries will contribute €200 billion to an emergency funding facility of the IMF. This is in addition to the €440 billion European Financial Stability Facility already established by European governments, and a permanent €500 billion facility called the European Stability Mechanism to be established by June 2012. This is in addition to the relief already provided by private banks in writing down and restructuring their loans by up to 50%.

These arrangements for bailing out stressed economies go a long way in dealing with the existing debt problem. But they do not deal with the fiscal problem that underlies the debt problem, namely, that most EU governments spend much more than the revenues they raise, especially in a variety of generous entitlement programmes of the welfare state. Unless these governments conform to prudent fiscal rules that align their spending with their revenues, the sovereign debt problem will keep recurring. Hence the most significant achievement of the last summit was the agreement by all EU governments, except UK, to commit to a fiscal compact. While this was a major step forward, details of how this will work are yet to be worked out.

In particular, governments committing to fiscal discipline will need to know what they get in return. There is no agreement yet that they would be able to raise loans through the issue of Eurobonds, which would be shared liabilities of all EU members. However, Mario Draghi, the new president of the European Central Bank (ECB), has hinted that the ECB may be open to significant purchases of sovereign bonds issued by countries that comply with the fiscal compact. It is still too early to tell whether this will be adequate to stabilise global financial markets, though some recent market signals are promising. If this were to happen, it could mark a significant turnaround for the world economy, including India.

It is reasonable to hope that a resolution of the EU crisis will unleash a rising tide of global economic recovery that will lift all boats, including India, in 2012. But it is quite disconcerting to observe the endless flip-flops on several key decisions at home – fuel price hike, FDI in retail, pension reform, Lokpal, etc. This is gravely eroding confidence in the ability of this government to manage the affairs of state.

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