Indian Economy: Transition to Take Longer Time

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Abstract

Indian economy is in a transition phase. After years of slowing growth coupled with rising fiscal deficiate and governments indebtedness the country witness a crises like situation in August 2013 when the rupee crashed and the soverign credit rating was on the verge of loosing its investment grade. It was no wonder that experts drew parellels with 1991. The change in the political scenario and policy making in 2014 was the key to pull the country out of immediate danger. This change in direction created a sence of celebrationparticullary on the Dalal street, which although typical, was somewhat premature. There is no doubt the economy has changed direction, but a number of hurdles including an unsupportive global economy and a weak monsoon have slowed down the process. The transition phase for the economy is likely to be longer than earlier anticipated.

Key words : *Inflation, Fiscal deficit*

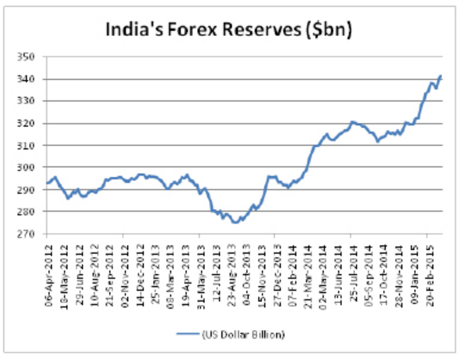
1. Introduction

Indian economy's transition from a slowdown to high growth is proving to be a longer and harder journey than earlier envisaged due to numerous factors. The slowing down global growth isn't helping, domestic reforms are taking time to fructify, the jammed up investment cycle is yet to pick up and challenges in agriculture have hampered rural consumption. The quick gains the economy made in last 18 months were mainly on account of favourable global trends including a sharp drop in commodity prices, particularly crude oil, and near zero interest rates in the major economies such as US, Japan and Germany.

II. Improvements in last 18 months

It was around mid-2013 that India was suffering from a number of economic problems —high inflation, rising current account deficit and a challenge to keep fiscal deficit within limits. The country's economic growth was slowing down and the sovereign credit rating was downgraded to a grade barely above junk. Rupee's dip to 68 against USD in August 2013 was a reflection of these problems.

Things have improved considerably since then. Inflation in wholesale prices has dipped into negative while at consumer level it has stabilised at 4%-6% range. The current account deficit, which had reached a high of 4.8% of GDP in 2012-13, narrowed down to 1.6% of GDP in Oct-Dec'14 quarter and is expected to turn into a surplus for Jan-Mar'15 quarter. With both these factors under control,rupee has stabilised around 61-63 against USD, even as the USD has strengthened to multi-year high levels against other major currencies such as Euro, GBP and Yen. The improving economics and strength in currency has reinforced global investors' confidence in the country as witnessed by the soaring stock exchange benchmark indices – BSE Sensex and NSE Nifty – both of which gained over 50% in FY2014-15.Foreign portfolio investors brought in Rs 1.09 lakh crore in Indian equities and Rs 1.64 lakh crore in Indian debt during FY14-15 — highest ever investments of Rs 2.73 lakh crore from overseas investors in India. The country's foreign currency reserves at $341.4 billion at end March '15 have risen to their highest ever level.



(Source:RBI)

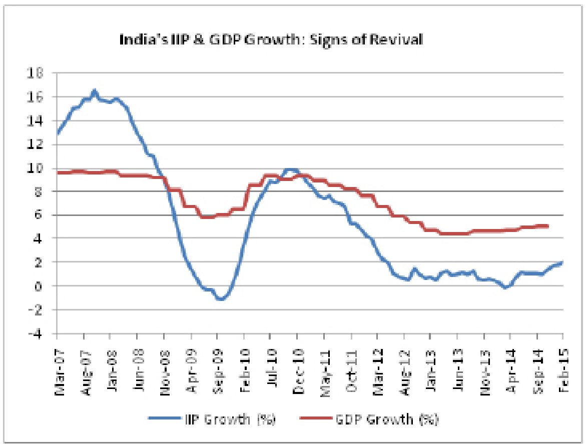
III. Factors responsible have been external

Most of these positive changes are attributable to favourable changes in the global economy including crash in the commodity prices, particularly crude oil where the prices fell over 60% from $115 per barrel in June 2014 to $45 per barrel in January '15. Similarly, the almost-zero interest rates in major economies such as the US, Japan and Germany forced even the most conservative investors to look for returns — through either debt or equities investments — in emerging markets. At the same time, the slowing down aggregate economic growth – or as IMF's chief Christine Lagarde put it recently, 'mediocre economic growth becoming new reality' – made India a preferred destination. All these factors helped India's problems of inflation, current account deficit, fiscal deficit as well as weakening currency.

However, these factors did little to jumpstart the country's internal investment cycle or improve economic growth dramatically.

IV. India's Economic Growth – A Work in Progress

The tailwinds created by the positive environment is helping the economic growth gradually improve, while the new political leadership aims to cut down red-tape, archaic laws, facilitate doing business and expand domestic manufacturing base. The index of industrial production — a gauge of factory output — gained 2.8% in Apr'14-Feb'15 period, as compared to 0.1% contraction in the corresponding period of previous year. The latest reading for Feb '15 stood at 9-month high of 5%.

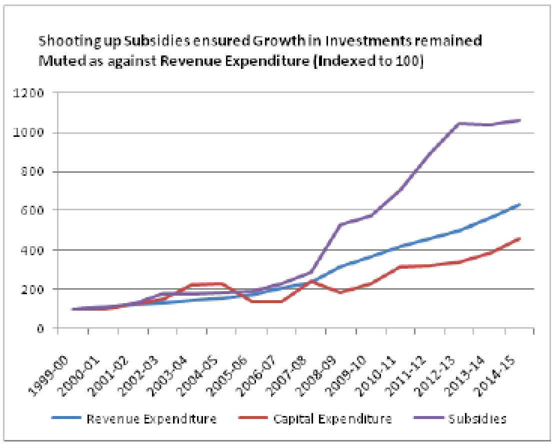


The government expects India's GDP growth in FY15-16 to range 8%-8.5%, as against 7.4% achieved in FY14-15 according to the revised series introduced recently.

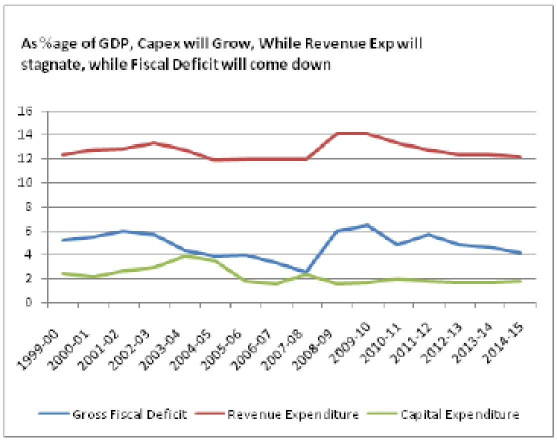
Source: RBI

V. Government's Initiatives

In this regard, the government's Budget for year 2015-16 has marked a change in the trend of last decade where the spending on asset creation gradually slowed down, but that on salaries, interest or subsidies shot up. The government's spending for infrastructure — more particularly, roads, railways and power — will jump 25.5% for FY15-16, as against growth of just 2.5% in FY14-15. On the other hand the revenue expenditure growth will come down to 3.2% in FY15-16 from 8.5% last year.



Source: RBI



Source: RBI

India's growth ambitions have been impacted due to inadequate infrastructure that hurt not just ease of doing business, but the overall quality of life for the people. Hence, in addition to increase the direct spends on infrastructure creation, the Budget announced creation of National Investment and Infrastructure Fund (NIIF) with annual inflow of Rs 20,000 crore and tax free infrastructure bonds.

Government's initiative to boost infrastructure spends is also an important way to revive the investment cycle, which had slowed down due to over leveraged corporate balance sheets, delayed projects and restructured loans in the banking system.

India's bank credit growth – an important parameter of fresh investments taking place in the economy – grew at an 18-year low growth rate of 12.6% in FY14-15 according to RBI data[1]. The growth in corporate borrowings was merely 3.5% while the personal borrowing — for vehicles, housing and consumer durables — was the driving force. This shows that fresh investments are not taking place and even the past projects are stuck up – something the new government has not been able to solve yet[2].

VI. Better Fiscal Maths

Another positive thing about the recent Union Budget was credible fiscal maths, which make the revenue and deficit target achievable, something that was lacking in earlier budgets. The government tweaked the tax rates for FY15-16 in such a manner that the excise and service tax collection would grow to enable tax revenues to grow 15.8% year on year or by 0.4% of GDP. This will enable funding the additional cost burdens emerging from implementation of Goods and Services Tax (GST) from April 2016 and recommendations of 14th Finance Commission that increased the devolution of states' share in taxes by a massive 10 percentage points. Earlier this year, the YV Reddy-headed 14th Finance Commission had recommended a hike in the States' share of the tax divisible pool to 42% from earlier 32% for each year.

The government finances, at state as well as central level, are also getting strengthened with the auctioning of natural resources. The government's recent move to auction 33 coal mines and telecom bandwidths netted Rs 3.1 lakh crore, with more coal mines to undergo auctions in due course.

All this will contribute to reigning in the fiscal deficit to a targeted 3.9% of GDP for FY15-16, a critical thing when it comes to sustaining the investor confidence in the economy. Moody's, one of the world's leading credit rating agencies, recently changed the outlook on Indian economy to positive from stable, while maintaining its rating.

VII. Some Improvements, But More Needed

Although there is certain improvement at the macro level, percolating that to the ground level will need some time. The improvements are considerably feeble with corporate profitability under stress and investment cycle stagnating. There is reason to believe that the government might have overestimated its power to turn the economic cycle for the country [4]. Revival of the stalled investment cycle will play a key role in creating more jobs and boosting the spending power of the people, thereby driving consumption led growth. However, government's efforts in this direction —the 'Make in India' initiative or policy to domestically source defence goods or push for green energy — have yielded limited results.

VIII. Hurdles to Overcome

The economy's transition is facing a number of challenges. The poor state of Indian agriculture is foremost of them. The kharip season of Indian agriculture suffered in 2014 due to poor monsoon, while the rabi season took a hit from unseasonal rains and hailstorms. Going ahead, for 2015Indian Meteorological Department(IMD) has predicted increasing probability of poor monsoon rains. Since nearly 60% of India's population is directly or indirectly dependent on agriculture, poor monsoon will have the effect of suppressing rural demand. Crisil, one of the leading credit rating agencies in the country, has predicted an impact of 50 basis points to India's GDP growth rate of FY2015-16 due to below normal monsoon [5].

Secondly, India's exports are coming under pressure from a subdued growth in other countries and relatively strong rupee. Federation of Indian

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Export Organisation (FIEO) recently predicted India's exports in FY16 would struggle to reach $300 billion mark, when it achieved exports of $310 billion for FY1 5[6]. Empirical evidence suggests that exports growth has always been an important factor in any economy's fast growth.

Similarly, global events such as tensions in the Middle East, possibility of Greece's exit from the Eurozone, likely rate hikes in the US or Russia's aggression against Ukraine could create global uncertainties that will have negative impact on Indian economy. While the Indian economy's structural strengths — demographics, democracy and demand — are now supported by a pro-business government creating a large potential, such events may postpone the expected economic growth to later years.

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