The Economic Morass and the Way Out

The gloomy global scenario has finally quite visibly started casting a shadow on India. A noticeable slowdown in manufacturing sector, sharp slump in industrial output, decline in mining output, some delay in reforms, high inflation and rising interest rates have pulled down the Indian economy's growth to 6.9% in the second quarter, much lower than the 7.7% growth recorded in the previous quarter this fiscal. The economy has slumped to its lowest in more than two years while output expansion at key industries tumbled to a six-year low. To make the matters all the more worse, a slowing economy and less than buoyant revenues are making fiscal deficit slip out of control. Further, many economists say that India may face its worst financial crisis in decades if it fails to stem a slide in the rupee.

Another casualty of the uncertainty in global economy and some delay in decision-making is the 'investments'. The Gross Fixed Capital Formation (GFCF) has registered a negative growth of minus 0.6% in real terms for the latest ended quarter. This had earlier happened in January-March 2009 — the peak period of earlier global financial crisis. Also, the GFCF as a proportion of GDP at current prices (more commonly known as investment rate) has slumped to 28%, which is about the levels in 2004-2005.

Meanwhile, according to data released by Controller General of Accounts recently, the fiscal deficit for the first seven months (April to October) of the current fiscal has already hit 75% of the targeted deficit for the entire year. This has serious implications for domestic inflation since a large fiscal deficit is an important contributor to overall demand pressures. The Centre has pegged the fiscal deficit target for 2011-2012 at 4.6% of GDP, but in view of current estimates fiscal deficit can be as much as 5.7% of GDP.

Yet another related major area of concern is the slide in Indian Rupee by more than 16% in the past four months — to about 53 per dollar after touching a low of 54 per dollar recently. The drop in the portfolio inflows and the hefty current account and fiscal deficits have been a key factor behind the rupee's decline. As Europe's banks deleverage, investment money has flooded out of India's markets. If Europe's debt troubles deteriorate, India could be hit with a balance of payments crisis as severe as the one that forced a sharp devaluation in 1991. In this scenario RBI is left with a difficult choice over how to make the best use of its limited $300 billion reserves to maintain the confidence of foreign investors. If the RBI is too timid, it risks adding fuel to the ire of portfolio investors, which India relies on heavily to cover its imports tab.

However, when considered in the backdrop of serious global slow down, the decline in India's GDP growth is not all that disappointing. By all indications, the slowdown is only temporary and unlikely to jeopardise India's long-term growth story if investments keep coming. The Indian economy is, in some ways, better placed than many other nations to withstand a fresh round of global economic turmoil. India's resilience results from the fact that the bulk of India's GDP is domestic demand driven. In fact, our top policymakers have also exuded confidence that overall growth would be 7% to 7.5% this fiscal, but not without 'hard days' ahead, particularly in the third quarter. Finance Minister Pranab Mukherjee said: "I am expecting that the present downturn will be temporary and our economy will soon revert to high growth," adding that "basic fundamentals of the Indian economy *are still strong. Rate of savings is high. Yes, it is not as high as 35% to 36%, but it is around 33% to 33.5%. Rate of investment is around 34% to 35% despite depression*." Planning Commission Deputy Chairman Mr. Montek Singh Ahluwalia attributes the fall in GDP growth mainly to the fall in investments, but expects the economy to rebound in the fourth quarter with overall growth rate of 7% to 7.5%. Prime Minister's Economic Advisory Council Chairman Dr. C. Rangarajan says that expected improved performance in agriculture in the third and fourth quarters should help the economy record annual growth of 7.5%.

A way out from the current economic morass is that the Government expedites the decisions on various issues linked with our growth and does a big balancing act. The reforms need to be stepped up to enable fiscal correction, and resources need to be redeployed from wasteful consumption expenditures to productive investments. More avenues need to be opened for investments and allowing 51% FDI in multi-brand retail is economically a good move if implemented with adequate checks and balances. It is good that the RBI, which has raised rates by 375 basis points since March last year, has put a brake on its tightening monetary policy for the first time in the current year keeping all the policy rates unchanged in the recently Mid Quarter Review of Monetary Policy for 2011-2012 in view of somewhat encouraging inflation numbers. Indeed, the RBI cannot afford to relax its guard on inflation which has continued to remain above 11% for almost a year now. The successive repo rate hikes have done little to curb inflation, but have considerably impacted investments by making capital more expensive and eating into the profits of the firms. So far as fiscal deficit target is concerned, a big balancing act and fiscal consolidation is the need of the hour. However, any reckless cuts in Government expenditure may not go down well with growth prospects. In this regard, the Chartered Accountants, as the backbone Indian financial system and facilitators of fiscal prudence and financial discipline, can play a pivotal role in boosting the growth. The current situation demands that all the forces having stakes in Indian economy join hands for national and global benefits.

-Editorial Board
ICAI-Partner in Nation Building