The Indian economy should be prepared for myriad challenges

The Centre's tax intake offers comfort for its capex plans but it may need some fiscal ammunition

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The world is going through a rather complex and painful phase. While most economies were already suffering from slow growth and high inflation induced by the pandemic, the recent Russia-Ukraine war has aggravated the challenges. Global commodity prices are on a boil even as supply bottlenecks for some critical food items and raw materials are a concern. While growth remains a challenge, major central banks have no choice but to start monetary policy tightening to counter high inflation. The Indian economy, which was just about limping back from the pandemic and other domestic concerns, has also gotten embroiled in this.

Recent challenges have resulted in India's economic growth projection for 2022-23 being lowered. At a projected gross domestic product (GDP) growth level of over 7% for the year, India is still better placed than many others. This is not to deny challenges emerging from many quarters, which if not tackled appropriately could result in a further slowdown. Most importantly, consumer sentiment and consumption spending that were marred by the pandemic are still weak. Private consumption, with a 55% contribution to GDP, is a big pillar of the economy. Hence, it is very important for it to improve. Consumption GDP has only improved marginally in 2021-22 over 2020-21 (pre-pandemic level), while high-frequency indicators like IIP consumer goods data remain weak. On the investment front, so far the government sector had been holding fort even as the private sector was wary. We can expect a positive shift in this as capacity utilization levels grow. The private intent to invest has risen, as reflected by a jump in the data on new investment announcements tracked by the Centre for Monitoring Indian Economy. However, a meaningful improvement in the private capital expenditure cycle would be contingent on continued improvement in capacity utilization and a stable macro-economic environment.

The employment scenario presents a sharp dichotomy. On one hand, there is a huge demand for value-added jobs in the IT and financial sectors, which are in a struggle for talent. On the other hand, job losses are rising in the lower value-added spectrum as many urban workers have lost their jobs.

Rising inflation due to high global commodity prices is another challenge. While inflation is mainly due to supply-side factors, prices have risen across most categories. This is dampening consumer sentiments and putting pressure on the margins of producers. The rise in Wholesale Price Index-based inflation is sharper than Consumer Price Index inflation, which suggests that retail prices could go higher still.

Challenges on the global front have also created vulnerabilities for India's external sector. As exports feel the sting of slowing global growth and import bills are driven up by high commodity prices, India's current account deficit is expected to widen in 2022-23. Unfortunately, the economy is also witnessing foreign portfolio investment outflows as the US Federal Reserve prepares for further rate hikes. Even while foreign direct investment flows remain healthy, India's Balance of Payments will feel the pinch. This has already resulted in foreign exchange reserves falling and the rupee weakening. A weaker rupee can worsen imported inflation.

In a nutshell, there are challenges galore at this point for the Indian economy. However, the country is still better placed than many other economies in this period of global turbulence. While inflation is rising in India, the rise is still not as sharp as that in many major economies. Abundant liquidity has still not resulted in patches of the economy heating up. For instance, in economies such as the US, UK and Australia, the real estate market has got heated up. There has been a sharp spike in property prices due to abundant liquidity, requiring the urgent attention of policymakers. With that not being the case in India, the Reserve Bank of India has the comfort of going slow in its withdrawal of monetary accommodation. However, with inflationary pressure so persistent, it needs to start hiking policy interest rates now and reduce liquidity in the system to make rate hikes more effective. As inflation is mainly because of supply-side factors, monetary policy action will have its limitations. But at this juncture, it is important to anchor inflationary expectations to prevent a wage-price spiral.

As far as fiscal stimulus is concerned, limitations exist, as upward pressure is exerted on India's fiscal deficit by a burgeoning subsidy bill. The government will be wary of any further stimulus immediately as the current challenges may turn out to be a long-drawn affair. In this situation, the government will have to keep some ammunition ready for use. However, it should consider a cut in fuel taxes, as high fuel inflation has major second-round effects and can heavily impact household inflationary expectations. The comforting factor on the fiscal front is that tax revenue collections have lately been robust, which gives India's government a cushion to go ahead with its capital expenditure plans. This is much required at this point, as private players may still be indecisive on their capital expenditure plans on account of economic uncertainties. It will also lay the ground for long-term sustainability of the country's economic growth story as the current headwinds subside.