Rebooting India's Economy-The Roadmap Ahead

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Good morning friends.

I would like to thank Sydenham Institute of Management Studies, Research & Entrepreneurship Education (SIMSREE) for inviting me for this prestigious financial festival: FISCUS'14.

Talking about and discussing issues pertaining to the Indian economy is never too much given that the country is literally at the proverbial crossroad and there are multiple options in front of us and our choices need to be right. Given our own experiences in the last couple of years, one is not too sure what is the right path and as we have seen, there have been a multitude of suggestions being given almost every day for the government to do. But we still have not quite managed to hit the bull's-eye.

In this world of technology where we look at the online mode for transacting everywhere, it is only appropriate that we have named the subject before us to discuss – ***rebooting the economy.*** If you think deeper, and look at all that has transpired in the last few year, you will agree that we literally have to put off the switch and put it on again if we are to choose the right road. We need to choose our options carefully since we can several countries turning around the corner this year and we have to ensure that we do not get left out. There is nothing amiss with the server, but things have gotten into a hang somewhere, and we need to reboot our system.

Let us try and first understand how we came where we are.

India prior to crisis

Between FY04-FY08, the Indian economy grew at an average of 8.7% making it one of the fastest growing countries in the world. Capital formation was on an upswing. India had acquired the status of a key emerging market economy. Subsequently, the country became a hot spot for foreign investment inflows given the high returns on investments across the spectrum. Surely, with such a vast market size and growth figures of over 9.3% for three consecutive years of FY06, FY07 and FY08, there was little doubt over the country's credentials leave alone its potential. All of us assumed that there was only one way that we could go, and that was in the upward direction.

Financial crisis and its aftermath

The magnifying financial bubble in the USA eventually burst in 2008, which is common knowledge. US entered its worst financial crisis in modern history dragging the world with it. Contrary to the belief that India was insulated from any direct impact of the crisis, it was in fact the aftermath of the crisis which dented India's growth story from 2009 onwards.

- Firstly, foreign funds began to drain out causing Indian corporates to substitute their financing from overseas sources to the domestic credit and money markets thereby imposing increased pressure on them.
- FOREX market was also under stress given the reversal of foreign flows even as corporates' demand for the US greenback elevated in order to honor their external obligations. As a logical consequence, Rupee took the plunge.
- To add to the financial stress, the real sector of the economy was also affected due to the slowing global demand for Indian exports. Lastly, overall global confidence had hit a low as all players in the world of finance adopted a risk-averse attitude.

In order to counter the crisis, the Government at the time adopted a fiscal stimulus plan after invoking the emergency provision of the FRBM Act. In the wake of the stimulus, increased capital expenditure, infrastructure funds, reduction in indirect taxes among other measures took form. Additionally, there was a farm loan waiver package and increased salaries of government staff. All these measures were factored into increasing the domestic demand to keep economic activity in order.

As was anticipated, fiscal deficit accelerated sharply from 2.7% of GDP in FY08 to 6% of GDP in FY09. While this increased government spending did warrant two years of high growth of 8.6% in FY10 and 8.9% in FY11, what it also led to was inflation. Further, the country faced a major drought situation in 2009 which pressed the prices of agricultural produce. Overall, WPI inflation increased from 4.7% in FY08 to 8.1% in FY09. It peaked in FY11 at 9.6% and has been moderating at a steady but gradual pace since.

Apart from inflation worries, the previous government also faced hurdles in new policy forming by virtue of the opposition in the house. Hence, corrective policy measures were slow and as a result several projects came to a grinding halt due to the dearth of investments as the Government took to reining in the fiscal deficit ratio from FY13 onwards. Power, road and ports projects got held up which had negative repercussions through the industry-chain.

Additionally, there were certain controversies pertaining to the natural resources in the country. All of these factors together eroded the emerging market picture painted earlier in the decade. GDP growth slowed down to 6.7% in FY13, 4.5% in FY13 and 4.7% in FY14 from FY11 levels of 8.9%.
To top it all, the Fed announced the now famous tapering programme in May 2013, which caused panic in the market and the rupee toppled as the external balance was under pressure, and the RBI had to step in to correct the situation by invoking a series of steps.

Therefore, we had a situation of stagnant growth, high inflation, stalled projects, reluctance to take decisions and a rupee that had just about been put back on track. This was the time to really reboot our system to open the door for a new innings.

New government and current problems

There has since been a change of guard at the Centre as a new government coming into power with a lot of fan fare driven by a strong majority. The expectations from the government stand tall fuelled by substantial optimism regarding the course of economic growth among other macro parameters. However, at the outset, as the Government took charge in office, its task was on the uphill.

As identified earlier, the challenge was to spur growth in an environment where industrial output recorded negative growth in FY14, GDP growth stood below 5% levels and inflation was an omnipresent issue even as the RBI emerged from the crisis like situation of FY14 and kept the balance of payments in check after curbing imports of gold.

The government has started on the right note, and if the Sensex is the barometer of sentiment, it is more than positive.
The government has so far put in place several new policies across sectors. In the financial sector in particular, it has raised the FDI limit in railway equipment and defence sector and announced policies which induce more savings among the people. Several corrective projects were announced in the agriculture, sanitation, corporate affairs, energy, mining sectors. All of these measures were seen to assist making the environment more conducive. Stalled projects have been cleared to ensure that red tape does not create roadblocks.

However, it should be remembered that these announcements are unlikely to bring about any immediate and material turnaround in the country. For instance, the government set up certain key policies in the agriculture to discourage hoarding and permit free flow of agricultural produce in the country. Several projects which were earlier held up due to clearance issues were cleared off by the Centre this is why number of stalled projects in the country is receding. Hence, overall, the primary goal for the short term appears to be directed towards improving governance. This provides the right enabling environment but we need to go further.

However, to my mind, the economy as of today still faces the challenges of

- Low growth,
- high inflation and
- stagnant investments.

These issues are pressing more so because the government is onto a fiscal consolidation path and hence it would be beyond logic to hope for high government spending as in FY09. Further, given that the India's economic growth is not driven primarily by exports, that leaves only one possible method to reboot the country and that is by domestic demand. It is **domestic demand** on its own that can thrive and mobilize the real sector of the economy. Logically then, domestic demand has been subdued in recent years owing to high inflation in the country. If explained with figures, annual average retail inflation was 9.5% and wholesale inflation was 6% in FY14. Thus, while this does appear cyclical in reasoning, there is a starting point to address the concerns of both reduced demand and high inflation.

Firstly, a good starting point would be to focus on **agriculture.** As we are aware, the dominating force behind high inflation has been food inflation. Adopting strict vigilance and discipline in this sector will answer some of the key issues pertaining to inflation at large. There is a dire need to improve the value chain in agriculture. As has been reiterated at various forums, the production side of agriculture ought to see some improvement. Certain measures to better facilitate the transfer of agriculture produce from the farms to retail stores if introduced can go a long way in reducing wastage and spillage. While the government has reduced its food subsidy in the Budget for FY15 to Rs 23,000 Cr from the earlier level of Rs 92,000 Cr, better pricing policies and anti hoarding policies will discourage any uncalled for surge in food prices. It has also decided to establish a warehouse infrastructure fund to reduce the wastage of agricultural produce and to strengthen the value chain. Food, beverages and tobacco carry a weight of 49.7 in the CPI. Hence, any relief to agricultural produce prices will certainly translate into a lower inflation figure.

Coming to **demand now,** as mentioned earlier, demand has been constrained by inflation. Hence, first let me discuss inflation and its relationship with the RBI briefly. Clearly, inflation has engulfed the RBI since FY14. Ever since Governor Dr. Raghuram Rajan took the office last year, the repo rate has been hiked by 50 basis points from 7.5% in September '13 to 8% in September '14. Time and again it has been reiterated that inflation will be the key factor influencing interest rate decisions and RBI is determined to remain on the disinflationary glide path with the goal of 8% CPI inflation in January '15 and 6% in January '16. For the last month of July '14, CPI inflation stood at 7.96% reversing its moderation in the previous month on a year-over-year basis. It does appear to be within RBI's target of 8% however going ahead there remain threats to inflation. Global geopolitical unrest continues to surface and this will deeply affect domestic oil prices. Further, the country has witnessed lower than normal monsoon this year in the wake of the supposed El-Nino effect. Further, the recent floods in certain regions threaten to hamper crop cultivation. It thus remains to be seen how agricultural output prices move from here on. This again reiterates the importance of focusing on agriculture. Hence, certain additive measures in agriculture should assist controlling the price rise.

Coming back to demand then, indeed reviving consumption is a challenge when inflation is high. However, now assuming that the agriculture sector policies and improvement in the supply chain does bear fruit, there are some other measures which would contribute to reviving demand. For instance, **creation of jobs** will better the spending capacity of the population at large and in turn push demand. Also incomes, that too real income, need to rise in order to enable people to spend more. The country is entering its annual festive season when consumer demand usually increases. Hence, it can be capitalized by inducing more spending. So, one can expect a turnaround there.

However, despite the desired rise in demand, it would be unreasonable to expect industry to grow by 8-10%. On the contrary, companies should rather make peace with a gradual growth by reworking their existing plans. It would be useful to build certain **cost effective business models or customize products** to the particular income level of the final consumer. Overall, as demand increases it will also account for a rise in credit growth in due course which is only going to mean well.

Nest, **investments need** to flow into industry. While the government has cleared the existing projects, there has still not been adequate work towards more investments. The Government will have to initiate this albeit in fiscal capacity and within its fiscal consolidation roadmap. The state Governments could also potentially par take investments to support industry. State Governments have a reputation of being better managed and governed and are rather sound financially. The private sector can be expected to enter aggressively only once interest rates see some easing. Also, on this note then the Government seems to be open to the PPP model which will be effective in the current scenario to spur investments. The infrastructure sector in particular has been deprived of much progress as projects were held up for a prolonged period earlier and PPP projects in the sector will foster growth.

The importance of **fiscal consolidation** mentioned briefly earlier cannot be undermined. The government has accepted the preceding government's target of a GFD of 4.1% of GDP for FY15. The Government appears determined about meeting the target to keep fiscal discipline. Hence, government spending will be better directed in the ongoing fiscal. Meeting with fiscal deficit targets is a critical point while evaluating the Government's finances and performance.

Lastly, another key element for rebooting the country going ahead is going to be sustained foreign funds. In FY14, Net FIIs were outward bound. However, the net FII inflows in FY15 stand at approximately $22,540 mn. While being high in both verticals, foreign investors have preferred to invest in debt securities over equities. This can be tapped further by improving the domestic environment. It is critical at this juncture to improve the ease of doing business in India. India is currently ranked 134th out of a group of 189 countries by the World Bank on the ease of doing business. Evidently, this can be bettered upon. On an optimistic note, if the Gujarat model is replicated for the country at large, the business environment can be viewed to improve markedly. While opening up FDI in defence and insurance is a positive step, one senses that more than the obvious needs to be done. There has to be an overall improvement in the business environment.

On a concluding note, I insist that while it is safe to say that the challenging period has already been surpassed, there still remain clear steps to spur the Indian economy which are identified to be focusing on agriculture, controlling inflation, encouraging investments, maintaining the fiscal consolidation path and improving the business environment at large. The capital markets has been signaling a big thumbs up so far, but we have to make these gradual changes and improve the economic numbers as these indices can come down as fast as they went up. Clearly, there is need to show urgency after these first 100 odd days have passed.

I am sure the deliberations to follow will dissect these issues further in detail so that when we leave this hall in the afternoon we are wiser.

Thanks you again for giving me this privilege and wish you all the best.