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Responding to Economic Developments

What is the issue?

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The economic indicators of the recent period call for shifts in policy response to boost the economy.

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What do the economic indicators show?

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- **Growth** - The recently released quarterly estimates showed lower-than-expected July-September growth number for GDP.
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- With this, most analysts have lowered their full-year growth forecasts, with some projecting second-half growth at under 7%.
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- The encouraging sign is a pick-up in investment which was depressed so far.
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- But even this is overshadowed by declining consumer spending.
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- The Reserve Bank recognises this, but continues to project full-year growth at 7.4%.
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- Even that implies a second-half growth rate of only 7.2% which is no better than the unsatisfactory trend rate from 2014.
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- **Inflation** - Inflation has dipped more sharply than expected.
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- The current rate has been below RBI's target of 4% for the past three months.
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- Agricultural price inflation is lower still.
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- The quarterly GDP numbers record a sharp deterioration in terms of trade for agriculture.
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- This explains farmers' distress in many states, even as depressed rural wages have contributed to poor rural demand.
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- **Fiscal deficit** - The full year's fiscal deficit target was crossed by October-end (in seven months).
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- The government insists that it will stay within the full-year target of 3.3% of GDP (down from 3.5% in the last two years).
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- But there is the growing possibility that it will be able to do so only by withholding payments that are due on various counts.
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Is the response appropriate?

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- **Government** - The first two indicators (economic growth and inflation) point to the need for an economic stimulus.
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- This is especially needed when demand growth is slowing.
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- But the policy response is far from it and the government continues to insist on sticking to fiscal contraction.
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- **Banks** - RBI on its part argues that it needs more time to understand price trends, and therefore has not lowered its policy rate of 6.5%.
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- Loan rates in the market are too high. Most banks have a lending rate of over 9% for their best customers.
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- E.g. HDFC's home loan rates range from 8.8% to 9.5%, at a time when house prices are falling. Naturally, housing demand is low.
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- Small and medium enterprises borrow at much higher rates of interest.
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- The effective borrowing rate for majority of companies is more than their

return on capital employed which make it “unaffordable”.
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What should be done?

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- Both the government and the RBI should re-examine their positions.
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- Interest rates need to drop if there is to be broad-based economic revival.
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- The fiscal stance should be less rigid as inflation is below target and the danger of runaway oil prices has also passed.
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- There is thus a legitimate case for government to allow deficit level to inch up to a more realistic 3.5% of GDP, the same level as in the last two years.
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- That will be a neutral, not expansionary, stance, easily justified in the current situation, and realistic.
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- Besides this, there has to be a policy package to shore up agricultural prices, especially for crops with greater price volatility.
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- The target to double agricultural exports is a start, but more needs to be done swiftly.
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Source: Business Standard

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