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The policy stance of the Modi government

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As the Narendra Modi-led National Democratic Alliance government completes four years in office, the effects of disruptions such as demonetization are fading, and the benefits of the goods and services tax (GST) are kicking in ever so slowly. However, the problem is that the efforts of the past four years could be swept aside by exogenous factors, especially runaway crude prices and the ramifications of trade disruptions. So it's rather interesting that growth will still move up this fiscal even as parameters such as current account deficit, inflation and interest rates worsen and the pressures on government finances rise.

The policy stance: To its credit, the government has avoided short cuts to growth using monetary and fiscal policies and most of the reforms/repair initiated in the past four years remain works in progress. These will bear fruit in the medium to long term, if relentlessly executed. Tailwinds from low oil prices and distance from elections had helped the Modi government pursue such a policy stance. But the situation is now reversing, with the election due next year and Brent crude prices surging to \$80 per barrel. In such a milieu, the urge to abandon the pursuit of higher "trend" growth and push for "cyclical" growth/redistribution through populist policies would be strong.

The macros: Over the past four years, most macroeconomic parameters have improved, with lower volatility. Gross domestic product has grown at an average of 7.3% in the past four years, which is lower than the 7.6% trend in the preceding decade. The slowdown became more pronounced last fiscal due to demonetization and GST hiccups. However, the economy is now bottoming out and returning to its long-term trend growth rate. We expect India's GDP to grow at 7.5% this fiscal.

Retail inflation has declined through the past four years, aided by soft food inflation and proactive steps from government and the Reserve Bank of India's cautious stance. Improving twin deficit is another hallmark of the Modi regime, though some of the gains were reversed last fiscal, with 30 basis points slippage in fiscal deficit to GDP and the surge in the current account deficit.

One worrying aspect of the past four years has been the surge in non-performing assets in banking. Additionally, while improvement in macroeconomic balances and reform efforts pushed up foreign direct investments, they were not enough to move the business sentiment needle in a material way, as reflected in various business expectation surveys. India has also improved its global competitiveness position and ease of doing business rank due to the reform focus of the government. However, the corruption ranking (measured by Transparency International), after initial improvement, slipped in 2017.

Key successes and pain points: Direct tax compliance has shown a clear improvement in the

past two years, following the income declaration scheme and demonetization. Direct tax buoyancy improved to 1.9 in fiscal 2018 from 0.6 in fiscal 2016 as growth in direct tax collections accelerated even as GDP growth slowed down. GST, despite a shaky start, is expected to speed up formalization and further push tax compliance.

According to a World Bank study, 80% of Indian adults have a bank account today, which is the same as in China, and up from 35% in 2011. That said, issues of zero balance accounts and provision of financial services need to be addressed to improve financial inclusion. The digital medium has been leveraged for disbursement of subsidy and welfare benefits. These savings will amplify as the coverage improves, and, for that, upgrade of digital infrastructure will be critical.

The rural economy is straddling challenges, including slower agricultural growth, poor farm price realization, slowdown in construction activity, and sluggish rural wage growth. Measures that may help improve the situation in the short run, such as increase in minimum support price and the price deficiency payment scheme, are still at the deliberation stage. The good part is, the monsoon may be normal for a third

straight time, and there could be bumper crop production this fiscal.

Employment generation continues to be a challenge as construction has underperformed and manufacturing did not show a material lift. The recently released payroll data shows the economy is gradually formalizing, but it cannot be treated as conclusive evidence of employment generation. Given excess capacity and corporate focus on improving capital structure, private sector investments have

remained sluggish in the past four years. Political uncertainty due to an impending general election does not augur well for big-ticket private investments. Some improvement in investments is expected this fiscal with the government's focus on affordable housing and infrastructure creation.

Looking ahead: There is very little fiscal and monetary room for countercyclical policies to boost growth, and they would not be very effective as most of the problems plaguing the economy—be it manufacturing or exports—are structural in nature and can only be addressed via reforms. Many of the agricultural/rural problems too are structural in nature and reform measures to address them will bear fruit over the medium term. Rising oil prices, together with a weak rupee, create challenges in managing fiscal and current account deficits and also inflation. Fiscal slippage in fiscal 2018 and a renewed focus on loan waivers makes one worry. Only time will tell what stance the government will eventually take in the final and challenging year of its five-year term.

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