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Getting the economy back on track

It is important to understand the myth and reality of the current economic situation in order to map the road ahead

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Economics is a technical subject of interdependent variables and parameters, that allows for objective mathematical and statistical analysis. It is no more a single commodity demand-supply subject. Those in responsible positions who are ignorant of this fact end up trying to put a spin and gloss on reality, and thus get exposed soon as ridiculous, as we can see today in media debates.

Is it true then that the Indian economy is headed for a serious crisis? Yes, that is a reality. It is, however, a myth that any or every crisis necessarily means an imminent collapse of the economy. The Indian economy is not near a collapse yet.

The situation today in the Indian economy is therefore still retrievable and a turnaround can be commenced within three months if the government initiates "real" economic policy changes, as was done in 1991-96 during the tenures of Chandra Shekhar and P.V. Narasimha Rao as Prime Ministers.

Hence, no amount of quoting foreign agencies such as the International Monetary Fund, or international events in explanations will help address the crisis that is looming unless we initiate major economic reforms that are credible and incentive-driven for the people. We therefore need a reality check today.

A few basic facts

The reality of today can be assessed from the following facts. One, the growth rate of the economy with proper index number-based GDP has declined over the last two financial years. The annual rate for 2018-19 is for obvious reason not available, but my guess is the trend has not changed.

Two, household savings, which are the bulk of India's national investment, dropped from a high of 34% of GDP to about 24% of GDP in 2017. Non-household savings are about 5% of GDP. This decline happened even before demonetisation and the decline continues because of intrusive and sometime obnoxious tax measures. I consider the Goods and Services Tax (GST) a flop borrowed from the United Progressive Alliance (UPA) government. Despite my protest, it was introduced much as a carnival in Parliament, with gongs reverberating.

Three, non-performing assets of the public sector banks (PSBs) have also risen sharply, in fact at a rate of growth much higher than the rate of new advances of these banks, making many large PSBs financially unviable and likely to collapse. This could cause financial contagion in 2019 in all sectors.

Four, the Ministry of Finance has brutally cut allocations of the investments in infrastructure despite the urgent need for such infrastructure. The economy needs about $1 trillion investment in infrastructure to render "Make in India" a reality, but the actual investment in sanctioned projects is valued even less in real terms than the amount invested in the pre-2014 years.

Five, the manufacturing sector, especially MSMEs (micro, small and medium enterprises) which provide the bulk of the employment for the skilled and semi-skilled in the labour force, has been growing at abysmally low rates of between 2% and 5%.

Six, India's agricultural products are among the cheapest in the world, and despite a low yield

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per hectare, we are not able to increase the yield to its potential maximum and at least double the production and export the agricultural products abroad commensurately. Consequently, agriculture, as the sector that is the largest employer of India's manpower, is grossly under-performing.

Seven, when crude oil prices had steeply fallen over the four years since 2014, and despite the dollar value of the rupee till mid-2018 having been steady at around Rs.65 per dollar, nevertheless both exports and imports simultaneously declined over 2014-17.

The current adversity

Now today in 2018, the Indian economy is facing a 180-degree adverse situation: a rise in the rupee-dollar rate to 75, and crude oil prices rising to $85 per barrel, although they are lower now. This is causing a massive crunch for our foreign exchange reserves.

Thus the present possibility of an economic crash should galvanise us to review honestly the way we have governed and done the business of governing, and then rise to new heights with an appropriate change in policy, and thereafter achieve higher growth rates of 10%-plus annual growth in GDP, with structural changes.

The Union government also needs to give an alternative ideological thrust to economic policy rather than try to improve on the failed economic policies of the UPA, as is currently being done. In particular, first, the individual has to be persuaded by the government by incentives – for example, by abolishing the income tax – and not by coercion, such as harsh levies and taxes. Of course, the state should make no promise to the people without specifying the sacrifice required to be made by them to make it happen.

Second, India can make rapid economic progress to become a developed country only through a globally competitive economy, which requires assured access to the markets and technological innovations of the U.S. and some of its allies such as Israel. This has concomitant political obligations which must be accepted as essential.

Since the growth rate in the GDP is calculated as equal to the rate of total investment (investment as a ratio of GDP) divided by the productivity coefficient of capital (called "capital-output" ratio which decreases with increasing productivity and vice versa), a fall in the rate of investment and/or a rise in capital output ratio means a decline in the growth rate in GDP.

Thus if the rate of investment is 39% and the productivity ratio is 3.9, then the GDP growth rate is 39 divided by 3.9, which equals 10%. Thus higher the productivity in the use of capital (same as lower capital output ratio), higher is the GDP growth for the same level of investment – and vice versa.

The decline in the level of household savings thus had caused a sharp decline in the GDP growth rate. It is imperative therefore that to accelerate the GDP growth rate, government policy should be to incentivise the saving habit to increase the savings rate to 35% of the GDP.

To seriously address these priority problems, it is essential to implement a new menu of measures: (a) dramatic incentives for the household expectation and sentiment to save; and (b) lowering the cost of capital via reducing the prime lending interest rates of banks to 9%, by shifting to a fixed exchange rate regime of Rs.50 per dollar for the financial year 2019 and then gradually lowering the exchange rate for subsequent years.

Cause for optimism

On a positive note, we should bear in mind that in the last 71 years, India has always come out successfully in all crises – once this is acknowledged as such by policy makers, it can then be dealt with squarely with reforms that incentivise the people. On each occasion, such as the food crisis of 1965, the foreign exchange crisis of 1990-91, thereafter growth renewed on to a higher accelerating path.

A recent biography of Narasimha Rao by Vinay Sitapati shows how as Prime Minister, Rao relied on my blueprints prepared for reform led to economic reforms moving away from Soviet socialism to the market system and led to doubling the GDP growth rate rising from the socialist 3.5% annual rate of four decades (1950 to 1990) to the market fuelled 8.5% annual rate.

The Indian economy, however, needs to grow at 10%-plus per year for the next 10 years to achieve full employment and for India's GDP to overtake China's GDP and pave the way to form a global economic triumvirate with the U.S. and China.

We can no more be satisfied with 7-9% growth rate if we want to become an economically developed country by 2040.

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