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The GDP rescue act: Monetary policy is at a dead end

Beyond a point, the policy does not work due to specific obstacles to transmission channels.

Rupa Rege Nitsure

It was not a surprise that India's GDP (gross domestic product) growth slowed to 4.5 percent in Q2 FY20 -- its lowest in the past 26 quarters. All major leading indicators of non-agricultural growth, investment and consumption had hinted at this. Besides a slowing manufacturing sector, heavy monsoon rainfall in August-September had caused flooding across multiple states and impacted activity in mining and transport sectors. This had aggravated the overall economic slowdown.

In real terms, private consumption growth declined to 4.1 percent in H1 of FY20 from 8.5 percent in H1 of FY19 and gross investment growth to 2.1 percent from 10.8 percent. Credit extended by banks and NBFCs too has fallen steeply during FY20 so far, suggesting there is no sign of economic recovery in the near term.

The business inflation expectations survey of IIM-Ahmedabad for October shows that the business sentiment of sales and profits remained highly pessimistic. Looking at the slow pace of India's economic recovery, rating agency Moody's has cut the country's credit rating outlook to negative from stable, citing prospects of a more entrenched slowdown, weak job creation and increasing debt. But India's headline CPI (consumer price index) inflation has been steadily inching up since August due to sharp spikes in the prices of vegetables, fruits, eggs and meat and pulses primarily due to monsoon-led supply disruptions.

In short, Indian economy has settled in a bad equilibrium.

Against this backdrop, the response of the MPC (Monetary Policy Committee) to higher food prices in the upcoming policy review would depend on its assessment of the food price shock – whether it is permanent or transitory. We feel this phenomenon will not last long and food inflation will get normalized with a likely good rabi crop. However, the MPC needs to be more concerned with the faster decline in core (demand-pull) inflation to avoid bringing about undue volatility in output and employment. Hence, we expect the policy stance to remain accommodative.

At the same time, we do not want the MPC to reduce policy rates now, as it has reduced the repo rate by 135 bps since February, but policy transmission has stayed very weak both through banks (45-55 bps) and corporate bond market (75-80 bps even for AAA papers).

One percentage is 100 basis points (bps).

This highlights the constraints of monetary policy effectiveness in a phase of protracted slowdown. Evidence of its effectiveness during and in the aftermath of financial crises suggests that the monetary policy can do little to further stimulate economic activity or business investment. Typically, it is very effective at the beginning of the slowdown by reducing uncertainty and financial constraints to some extent. But

beyond a point, it does not work due to specific impediments to transmission channels like long-lasting balance sheet adjustment processes and higher perception of credit risk in the minds of lenders.

What India needs at this juncture is a more balanced mix of policies that would boost confidence for all economic agents -- investors, consumers and savers. A lot is already done by fiscal authorities, too. However, the government should not just spend more to boost sagging investment, but also work on making spending and taxation more efficient. Here, India needs measures to simplify the GST (goods and services tax) and bring the ‘direct tax code’ in line with global best practices.

While measures taken by the government so far are positive from the medium-term perspective, they do not address the immediate issue of “crisis of confidence” due to sustained contraction in demand. As suggested by some senior economists, the government should quickly shift its attention from mega projects to smaller core sector activities that have a quicker turnaround time.

Thanks to improved water reservoir levels and better prospects of rabi crops, rural belts have started showing early signs of mild recovery. The government needs to cash in on this and increase rural outlays (e.g., PM-Kisan, MGNREGS [Mahatma Gandhi National Rural Employment Guarantee Scheme] and rural road construction) to spur rural demand further. Also, the Centre, along with states and Union Territories, need to ensure quick disbursement of payments due to the private sector, which will improve purchasing power to some extent.

Rather than using the broad-brush tools of monetary and fiscal stimulus, the government needs to resolve pressing issues through sector-specific measures for key sectors like real estate, automobiles, power, telecom, NBFCs, etc. that have strong linkages to other productive areas. For example, capital injections to infrastructure sectors for re-energizing industries like steel, cement, ceramics, etc. and re-oiling supply chains or creation of a stressed asset fund for NBFCs (non-banking financial companies) to improve credit availability for the automotive sector, real estate and consumers, etc. would quickly help the broader economy.

Some measures like reducing the amount stuck in tax litigation or improving the ease of doing business at the state level may be given priority, given their fiscal neutrality.

Until capital returns to the economy, any talk of return on capital is fruitless.

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