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Cyclical or Not, it is not A Goldilocks Economy!

T.K. Jayaraman

Do you believe in the story of a shepherd delivering justice by sitting on the mound which, upon digging by a curious King of Ujjain, was found to be the seat of throne of the legendary King Vikramaditya?

That really happened when the Reserve Bank of India (RBI) stunned economists and the markets on December 5, 2019, by keeping its policy rate unchanged at 5.15%. Results of polls among economists by various newspapers and agencies taken weeks before the RBI's December decision were almost unanimous in their expectations in favour of a cut by a minimum of 25 basis points.

RBI Governor Shaktikanta Das is not known as a "hawk" in the tradition of Raghuram Rajan and Urjit Patel, who were professional economists with specialisation in monetary economics and finance with their well-known anti-inflationary bias. He was a civil servant with long years of experience, who was a handpicked bureaucrat last year,this time to replace Urjit Patel who had to resign due to differences with the government.

The Indian economy is growing presently at an annualised rate of 4.5% - which is not certainly low - but not as high as 7% or 9% as was recorded before. The worrying concerns were on the inflation front. The rate of inflation was dangerously getting closer to the targeted rate of 4% in the first quarter. It breached the limit in October 2019 when it reached 4.62%. The expectations are that inflation rate would climb up to 5.3% as vegetable and fruit prices were seen to be soaring.

The Monetary Policy Committee (MPC) chaired by Governor Das felt it was "prudent to carefully monitor incoming data to gain clarity on the inflation outlook" as the next round of data on inflation would be coming in December. Although the MPC recognised that there is some monetary policy space for future action, it decided "to take a pause at this juncture."

So, the RBI decision was to keep the policy rate of 5.15% unchanged. There were several suggestions made to the RBI from all quarters to do just the opposite. However, the central bank acted as it should. It thus fulfilled its commitment to maintain the mandated goal of price stability, thereby proving it is independent.

Not a Goldilocks Economy

Das and his five-member team of the MPC knew the Indian economy was not doing well. It is not going through the phase of what is most desirable, as "neither hot nor cold, as the legendary soup", which was welcomed by the bears in the popular children's story, Goldilocks and the Three Bears. Defined thus, in a Goldilocks economy, with a sustained moderate economic growth with low inflation, an accommodative, a market-friendly monetary policy is appropriate.

It is now a hot economy with inflation above the targeted rate of inflation - at 4%. No more cheap money policy. With massive cuts in policy rate by a total 135 basis points over during the calendar year, the economic juggernaut has not moved much. The growth rate has been declining. There are fears that transmission mechanism is not working, as the cuts have not been effectively passed through in full measure. Notable exceptions are there such as with State Bank of India leading the way to make cuts in accordance with the external bench mark, which is now the policy rate.

Impediments to growth

There are other impediments to faster recovery, besides the current prevailing weak governance factor: the credit growth has been sluggish. The public sector banks (PSBs), saddled with massive liquidity, prefer to keep balances with the central bank in non-interest earning deposits rather than lending to new borrowers. They are reluctant to step up more credit to old lenders, as the fear of being watched if they make bad decisions is looming large. The staunch critics lay the blame rightly on the fear psychosis which has been growing.

In these circumstances, non-bank financial companies (NBFCs) which were fulfilling the role of PSBs in credit to investors are now short of funds and are in crisis which began with the failure of IL&FS. NBFCs had borrowed short term from banks and mutual funds while lending to developers of long-term projects which got held up because of various factors. As cash flows dried up, NBFCs could not repay their lenders. Thus, we now have a triple balance sheet problem with PSBs or the banking sector relating to their loans (assets) and deposits (liabilities);

with corporate relating to their assets and debt; and NBFCs relating to their assets (loans) and liabilities.

Added to these impediments to any pick up in the growth, it is not surprising the RBI dropped a hint that anything that can be done is purely in the hands of the government. The actual words are: " …forthcoming union budget will provide better insight into further measures to be undertaken by the Government and their impact on growth".

A low key plea for fiscal expansion

The RBI's hint is similar to "a low-key plea for help from government" as noted by Richard Adams in his very incisive article in the Guardian of August 28, 2010 on the US Federal Reserve Bank chairman Ben Bernanke's Speech to the Jackson Hole Annual Economic Symposium, which is an annual event attended by leading central bankers and finance ministers of the world. It is worth re-calling the Fed Chairman's words from his speech at the Jackson Hole Annual Economic Symposium,

> "In many countries, including the United States and most other advanced industrial nations, growth during the past year has been too slow and joblessness remains too high … This list of concerns makes clear that a return to strong and stable economic growth will require appropriate and effective responses from economic policymakers across a wide spectrum, as well as from leaders in the private sector. Central bankers alone cannot solve the world's economic problems."

The RBI's hint, though similar to the low-key plea of Bernanke, is more revealing, as it appears that both the central bank and the government are consulting each other. Effective coordinating between them is certainly the need of the hour.

The RBI's Monetary Policy Statement of December 5 makes a reference to the upcoming budget in regard to boosting domestic consumption aside from corporate tax relief measures. Putting more cash in the hands of the monthly salary earners and government pensioners would certainly be an incentive. Cuts in personal income tax rates would be welcome. It is true that the fiscal deficit would exceed the targeted figure of 3.3% of GDP. But, it would be worth the effort.

Extraordinary times need extraordinary measures.

So, over to the government!

Dr T K Jayaraman is a Honorary Adjunct Professor, Amrita School of Business, Bengaluru and Research Professor, Faculty of Business and Research Professor, International Collaborative Research Program, Faculty of Business, Accounting, Finance and Economics, University of Tunku Abdul Rahman, Kampar Campus, Perak State, Malaysia