

“Money does not buy economic growth”

■ Dr. T. K. Jayaraman

As widely expected, the Reserve Bank of India (RBI) cut the policy rate on August 7, 2019 to make the economy move and grow once again. Policy rate is the rate around which all interest rates, both bank lending and deposit rate, revolve.

The purpose of the central bank’s cut in policy rate is to signal what the borrowing cost of money should be.

Instead of the usual magnitude of 25 basis points (bps), the reduction in the repo rate was by 35 bps. The RBI took special efforts to make it clear that the cut was substantial and unconventional, to impress upon all economic agents, investors, aspiring home owners, retailers, households, and consumers of durable goods.

On the same date, when RBI announced the cut, Reserve Bank of New Zealand’s policy rate, known as official cash rate/OCR (which is the interbank lending rate) was reduced by 50 basis points. The objective behind the rate cuts of two central banks is the same.

The central bank governor wanted the country to know he meant business. That gladdened the heart of the government that a former bureaucrat responded to its pleas as an easy monetary policy would move the wheels of the economy. Consumer confidence and investment environment are the most important factors behind growth.

Domestic Consumer Confidence

The consumer confidence index figures, released on August 8 based on the usual bi-monthly surveys by the RBI were uninspiring. The July round of the regular bi-monthly survey results (Table 1) based on information on urban consumer sentiments, gathered from responses to questions pertaining to general economic conditions, household circumstances, incomes, spending, prices, etc. from about 5400 persons (aged 21 years and above) in Bangalore, Chennai, Delhi, Hyderabad, Kolkata, and Mumbai didn’t generate confidence. Their responses are in two parts: current situation as compared to a year ago and expectations a year ahead. Table 1 shows that the index on current perception is in the pessimistic zone (any number below index

Consumer Confidence Index (Table 1)

Current perception compared with one year ago	One year ahead expectation compared with current situation
2018	
Sept 94.7	121.1
Nov 93.9	120
Dec 96.7	128.1
2019	
March 104.6	133.4
May 97.3	128.4
July 95.7	124.8

Source: RBI Monthly Bulletin Various issues

100 indicates pessimism) having fallen from 104.6 in March, 2019. It has been declining: in May, it was 97.3 and in July 95.7. Reflecting the same mood, the future expectations, though not in the pessimistic zone, are not on the optimistic trajectory either. The index for March 2019 was high, but declining: 128.4 in May; declining further in July.

Domestic Growth

The reasons are clear. The domestic economic growth performance has not been spectacular in the past few quarters. Tables 2 and 3 confirm the GDP annual growth rates are linked to industrial production and manufacturing quarterly growth rates.

Added to the domestic conditions, the external economic environment, which has been deteriorating is also causing concern. Growing uncertainties regarding trade relations between the two giant economic powers, USA and China, and the never ending retaliatory series of tariffs on each other’s goods have hurt the growth in international trade. Consequently, countries depending on exports for growth are now facing adverse conditions.

External Conditions

Already India’s export growth rate is in the negative zone, falling by 9.71% in June for the first time in the nine months. In his parting shot, delivered in his Hormis Lectures last month, the former deputy governor of RBI, Viral Acharya warned that India’s fiscal deficit in 2018 was already high, (according to the figures cited by him at 6.7% of GDP), which would only add to the worries on current account in balance of payments. Fiscal deficit for the first three months of the current financial year is reported to have reached more

Real GDP Growth Rates: 2018 Q1 to 2019 Q1 (Table 2)

Year	Growth Rate %
2018	
Q1	8.9
Q2	8
Q3	7.0
Q4	6.6
2019	
Q1	5.8

Industrial Production (IP) and Manufacturing (MFG) (Table 3)

Year	Y-to_Y Growth Rate %	
	IP	MFG
2018		
March	5.3	5.7
June	7.0	6.9
August	4.8	5.2
Oct	8.4	8.2
Dec	2.5	2.9
2019		
Jan	1.6	1.3
Feb	0.2	-0.3
March	0.4	0.1
April	4.3	3.98
May	3.1	2.5
June	2.0	1.2

Source: RBI

than 61% of the Budget Estimate.

Fiscal deficit and trade deficit are twins.

Trade deficits are often bridged by capital inflows in the past, by foreign direct investment (which is long term in nature), and portfolio investment inflows (which are short term in nature). Besides these two, inward remittances of Indians residing and working abroad touched a new high in 2018 at \$ 79.5 billion exceeding the second highest figure of received by China (\$67.4). Remittances are often referred to as unrequited transfers as overseas Indians do not expect any return as they are meant for supporting families left behind them.

Years ago, when a service charge by government of India was considered, Kerala, the largest recipient of remittances among Indian states vehemently opposed it as a tax on remittances, which were helping the poor families. As a result, the move was dropped.

Although FDI and portfolio investments are based on expectations of higher returns, portfolio investment funds, being of less than one year duration, are pulled out at the touch of a button. The short term expectations trigger outflows and inflows and so they are rightly called hot moneys.

The short terms return on portfolio investments to overseas investors comprises two components, namely, the interest rate differential and expectations on capital gains. More than interest rate differential, it is the expectation of the health of the economy that matters as gains or losses from shedding their investments in short term bonds and shares when pulling out their funds. Thus, both interest risks and exchange risks matter.

The adverse effects of India’s growing trade deficit are compounded by pulling out of funds by foreign investors. When the Indian economy was seen to be attractive to foreign investors during 2012-14, the annual net inflows were about ₹1-1.3 lakh crore. Then, the flows decreased to ₹17,000-20,000 crore in 2015 and 2016. After some improvement in 2017 and in 2018, foreign investors began to pull out again. From July till August 9 there has been a heavy pull out of funds: net outflows amounting to ₹22,000 crore so far. According to latest depositories data available on August 11, a net amount of ₹11,134.60 from equities was pulled out, while pumping in ₹1,937.54 into the debt segment during August 1-9, taking the total net withdrawal to ₹9,197.06 crore.

The perceptions of overseas investors are no longer favourable. It was not just the budget proposal of tax surcharge on foreign portfolio investors that was responsible for turning away the investors.

Depreciation fears

The effects of the net withdrawal and poor perceptions of the economy have brought the rupee to familiar, worrying of concern: \$1= ₹71-₹72 China is known for using depreciation of its currency as a weapon. China’s range of exports is far wider and superior than India’s. India cannot afford to welcome depreciation as a remedy to boost its sagging economy. On the other hand, any

further fall in rupee value would create additional problems for India in the event of a sudden spurt in oil price. Oil prices are denominated in US dollar and they have been volatile among all prices of critical imports

Will the “super-cut” of 35 bps work?

This would depend on how far the banks pass on the benefits of the cut in policy rate. Table 4 presents the details of the cuts in the policy rate. From February this year, the total cuts in policy rate by the RBI amounted to 110 bps of which 75 bps cuts were between February 7 and June 6. The weighted average lending rate came down only by 29bps. Further, despite the cuts, there wasn’t any substantial rise in bank loans. Rise in credit was only ₹2,274 billion, which is lower than last year’s ₹3,763 billion. Observers, including Madan Sabnavis, Chief Economist, CARE Ratings, puts the blame squarely on the declining demand for loans which is due to poor economic outlook.

Major factors influencing the demand are low capacity utilisation rates in consumer durable industries, including automobiles, caused by falling demand which ruled out any new investment needs and hence for bank loans. Decreasing infrastructure projects funding requirements was also one of the factors behind falling demand for loans.

Critics also point out that lack of liquidity is not constraining the economy. In fact, about nearly ₹2 lakh crores of excess liquidity had to be mopped up by the RBI as an anti-inflationary measure between June and July. Money market rates have also been below the repo rate.

It is all due to fear of lending in the midst of high non-performing loans, which have made bankers cautious and reluctant to lend aggressively. So, animal spirits continue to remain dormant.

That brings us to the question : What is the remedy?

The only remedy is that India should signal its intent in implementing structural and labour reforms, which have been postponed for one reason or another.

The government should also pursue the ongoing process of recapitalisation of banks, writing off loans, merger of banks and reducing the number; with a view to handing them over to the private sector. A time-bound programme and a target rate would suffice.

An announcement by government would do immense good! This government can do it. It has shown, as it has been accomplished by the boldest of bold decision, a long overdue integration of Jammu and Kashmir and Ladakh with rest of the nation. ■

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