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India has to paint itself out of its economic corner

Will Modi carry out fundamental reforms or continue to tinker?

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NEW DELHI -- Prime Minister Narendra Modi's announcement Monday of a \$2.5 billion program to take electricity to 40 million of India's poorest households bore all the hallmarks of his recent economic policies. Two-thirds of the way into his five-year term, Modi is pushing a pro-poor, populist agenda that could win votes for his Bharatiya Janata Party in general elections due by May 2019.



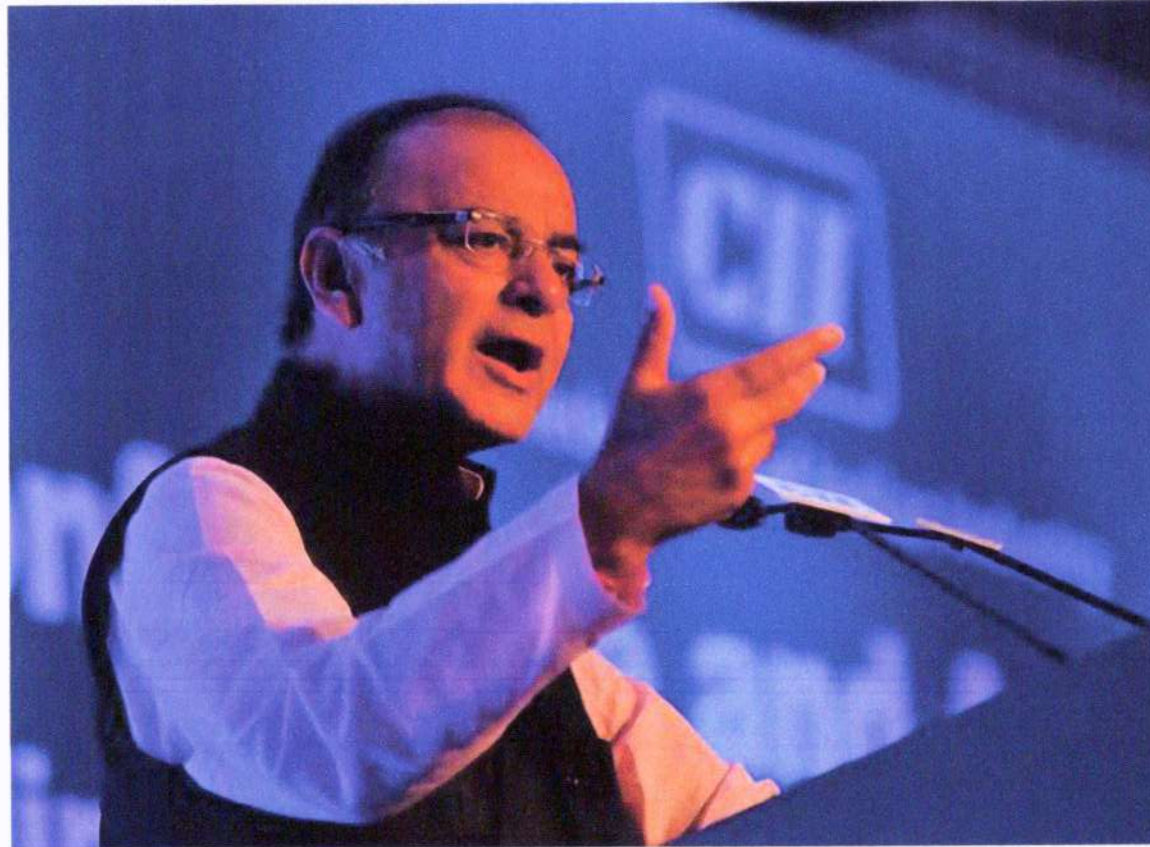
Indian Prime Minister Narendra Modi © Reuters

But analysts warn that Modi and Finance Minister Arun Jaitley are in danger of fiscal profligacy. There are strong signals already that the two men, fighting to keep the economy's wheels turning despite a sharp slowdown, are abandoning their pledge to bring the fiscal deficit down to 3.2% of gross domestic product in the fiscal year ending March.

Official data showed that between April and July, the first four months of the fiscal year, the government had already spent 92.4% of the total \$265 billion expenditure budget for 2017-18.

Jaitley said last week that he did not think there was any need to panic, but there was a need for analysis and for responsive action. Policymakers were conscious of the value of fiscal prudence, Jaitley said. "We are a responsible economy ... the real answer lies in finding the balance, and the balance lies in finding the resources."

Finding the resources to fund desperately needed infrastructure and create millions of jobs for India's burgeoning workforce is growing more difficult with each dismal economic indicator being published.



Indian Finance Minister Arun Jaitley (Getty Images)

GDP growth slowed dramatically to 5.7% in the April-June quarter from 6.1% the previous quarter. The Index of Industrial Production rose a meager 1.2% in July compared with a 5.2% rise in July 2016. The figure for the manufacturing sector inched up only 0.1% in July, compared with a rise of 6.3% a year ago.

Jaitley and his aides are piling immense pressure on the Reserve Bank of India to cut interest rates further, but the central bank's wariness about inflation seems justified.

Consumer price inflation spiked up to 3.36% in August from 2.36% in July and a low of 1.54% in June. Faced with the slowdown, the RBI is widely expected to trim rates for the second time in a row at its Monetary Policy Committee meeting on Oct. 4. But lower rates may only lift morale -- weighed down by nonperforming loans, banks have been lending less and less.

On a year-on-year basis, non-food bank credit rose at only 5.3% in July. The decline is stark: In July 2014, two months after Modi took office, non-food bank credit grew by 12.6%; in July 2015 by 8.4%, and in July 2016 by 8.3%. The plunge has been even sharper since the sudden demonetization in November.

In his Sept. 22 speech, Jaitley sounded almost plaintive: "How do you maintain the balancing act between continuing to spend, continuing to support your banks and strengthen them, and maintain some of the best standards of fiscal prudence? That last part is really the current challenge we are facing."

The finance minister has hinted that more steps are likely in coming days to revive growth. Casting around for straws to clutch, Modi on Monday revived the Economic Advisory Council, naming economist Bibek Debroy to the key post in the prime minister's office. Debroy will head a team of three other economists and a senior bureaucrat.

When he took power three years ago, Modi abolished the EAC in his hurry to discard the legacy of his predecessor Manmohan Singh. A few days earlier, Jaitley extended the term of his Chief Economic Adviser Arvind Subramanian by a fourth year. The government will not lack expert advice -- but it is getting poor marks in implementation.

One example is the ambitious \$6 billion National Investment and Infrastructure Fund. Launched in 2015, with the Indian government contributing 50%, the fund has failed to draw interest from overseas investors and sovereign wealth funds. The independent Centre for Monitoring Indian Economy estimates that a total 928 infrastructure projects involving outlays of 13.2 trillion rupees (\$203 billion) are stalled.

Losing faith

Sentiment is in a deep trough. The National Council for Applied Economic Research said its Business Confidence Index declined by 2.5% in April-June from the previous quarter. The BCI has swung wildly: In January it fell 16%, pummelled by Modi's shock demonetization, then rose 24.6% in April as businesses recovered, only to fall again over worries about the goods and services tax launched on July 1.

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Indian Finance Minister Arun Jaitley

Modi promised that the central government would fully fund the household electrification plan, targeted for completion by December 2018 just before the elections. But he was silent on how he would raise revenues for the program.

Power Minister R.K. Singh urged private companies to invest in the electrification plan, and said it would likely trigger thousands of new jobs. But most of India's mainly state-owned power companies are groaning under heavy debt loads. Investment bank Credit Suisse said in an August report that chronically stressed debt among companies stood at about \$190 billion, or 35% of total corporate debt, in the April-June quarter. Credit Suisse said 43% of private power companies were operating at less than 50% plant load factor, and operating profits at about half of India's power companies were not sufficient to cover one year's interest payments -- both signs of distress.

Still, Modi received the glowing endorsement of the National Executive of the BJP on Sept. 25, especially for the "historic steps" of demonetization and the GST. But the sheen is coming off Modi's reputation as a manager. The body blow to small businesses and small jobs from demonetization has been compounded by the messy roll-out of the GST, which was touted as "one tax for one nation." The GST's software backbone is proving to be cumbersome and error-prone; exporters for instance are up in arms over the glitches. Infosys, the main vendor, has been ordered to debug the software by end-October.

The BJP's political resolution claimed that GST would make life easier for the "trader community," the traditional bedrock of the party's support. Modi's popularity is still high, but with a series of state elections looming, the ruling party is clearly worried. It said: "The government is consistently resolving the difficulties being faced by the people and the traders during the initial period of the implementation of this tax."



Prime Minister Narendra Modi along with others pay tribute to Deen Dayal Upadhyaya on his birth anniversary at Vigyan Bhawan, on Oct. 9, 2016 in New Delhi. (Getty Images)

Modi likes to launch major initiatives on symbolic dates. Demonetization was launched on Nov. 8, eclipsing the U.S. presidential election. He announced his "Make in India" campaign on Sept. 25, 2014, the birth anniversary of Deen Dayal Upadhyaya, the BJP's presiding ideologue. Monday was Upadhyaya's 101st birth anniversary.

Although Upadhyaya advocated "integral humanism" and the concept of "Antyodaya" or the empowerment of the "last man," inequality has been steadily rising in India. In a paper published in early September, economists Thomas Piketty and Lucas Chancel say the top 1% of Indians controlled 21.7% of national income in 2013-14, up from 6.2% in 1982-83. This is the highest level since India's British colonial rulers introduced an income tax in 1922. The top 0.1% earners accounted for 8.6% of national income in 2013-14.

Speaking candidly, Jaitley told his audience last week: "There is no easy day in the management of the economy ... One analysis is clear: that India does need more private investment, and it needs a healthier banking system." He said nobody questioned India's ability "even on big-bang reforms."

A senior international economist said Modi is at risk of frittering away the huge mandate he won in 2014 if he ducks the toughest decisions. "He needs to reform the factor markets like labor and land. He needs to sharply step up spending on healthcare and education."

India is a classic "glass-half-full" case, the economist said. "It disappoints both the optimists and the pessimists," he noted wryly. "Five years from now are we going to wish Modi had doubled down instead of fixing the bells and whistles?"

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