The Descent Ahead*

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The Moody's decision, citing a growth slowdown and policy inadequacy, to downgrade India by changing its credit rating outlook to 'negative' from 'stable', and doing the same for a bunch of financial institutions and firms in the power and infrastructure sectors, has created a stir. At first glance the fuss is difficult to understand. There has been a consensus building even in 'Modi-friendly' circles, stretching from the international financial institutions to the domestic media, that the Indian economy has been experiencing a significant deceleration in growth. Hence, Moody's, whose credibility has in any case been suspect ever since the decade-old global financial crisis, was only belatedly recognising the obvious.

The tendency to give the decision more importance than reasoned judgement warrants stems from two sources. The first is that ratings by the top firms like Moody's, Standard and Poor's, and Fitch, influence investment decisions by major institutional investors. Insurance firms and pension funds, which are required to focus on highly rated, investment grade instruments and targets look to these ratings when they make their decisions. And, the second is acceptance of the fact that the reasons cited for the belated downgrade are warranted. Those reasons are a perception that the government's reform-driven response to the slowdown has been woefully inadequate, and that there are clear signs that the deficit on the government's budget is likely to far exceed the 3 per cent of GDP medium term target, and the 3.3 per cent provided for in the budget documents.

Hence, if fear that a Moody's-type assessment would influence investor sentiment, leading to an outflow of foreign capital from debt and equity markets, begins to guide government policy in the weeks and months to come, there is one kind of policy response that is foreclosed. That response is resort to a fiscal stimulus, which given the case against increased taxation in the midst of a slowdown in growth, can only be financed with borrowing and would in the short run widen the fiscal deficit even further. If fiscal consolidation and deficit control is made a priority, stimulating demand with government spending is ruled out.

This call for a conservative fiscal stance does make the task of engineering a revival difficult. The growth slowdown is the result of a shortfall in demand, as evidence from industries varying from automobiles to fast-moving consumer goods makes clear. That shortfall has has increased unutilised capacity and held back investment, accelerating the economy's slide. There are long term factors such as low and stagnant agricultural incomes and increasing income inequality underlying the slowdown. And export demand has not been an important driver of growth of India. But the effects of these factors were neutralised in the high growth years after 2003, because of a credit surge that drove an unsustainable boom in debt-financed private consumption and investment. As is to be expected, the credit surge, which was not warranted given the economy's fundamentals, soon led to defaults and large non-performing assets in different segments of the financial sector, forcing a slowdown in credit flow. In the event, the medium-term spurt in demand sustained by the credit surge had to give way.

Given these circumstances, the only feasible response to the slowdown was a fiscal stimulus in the form of enhanced spending that raises demand and gets the economy moving. Even if the government is reticent to raise taxes just now to finance such spending, it could borrow and spend, and choose to cover the costs of borrowing with additional taxes generated by and imposed in the aftermath of a recovery. That would have, of course, requires dropping adherence to fiscal consolidation and suitable modification of the debilitating Fiscal Responsibility and Budget Management Act. The 'fear of finance' and the government's own obsession with being seen as a "reformist" have, however, ensured that it has refused to exercise this option.

That stance is now proving to be self-defeating. To start with, since directly stimulating demand with enhanced expenditures is not an option, the government is experimenting with measures to spur private investment and demand. One policy track being pursued to that end seeks to spur flow of cheap credit to firms and households by getting the Reserve Bank of India to ease liquidity conditions and cut policy rates or the rates at which it lends to banks, and by persuading banks, especially public banks, to fatten their loan books. In its most recent monetary policy initiative, the RBI for the fifth time cut the policy (repo) rate to bring it down by a total of 135 basis points to 5.15 per cent. But burdened with non-performing assets and losses due to provisioning for bad debts, banks are not passively transmitting the stimuli originating in policy decisions of the central bank, by reducing their lending rates. Lending rates are proving to be sticky as banks retain the benefit of lowered costs of capital to partially adjust for losses and credit flow remains sluggish as banks focus on clearing their books of accumulated bad debt.

With the reliance on the monetary lever as a substitute for, and not complement to, fiscal policy not delivering results, the government has looked to other supply side measures to boost private investment. After experimenting with a range of half-hearted measures, including a partial withdrawal of surcharges on capital gains made by portfolio investors and on incomes of the 'super rich', the Finance Minister Nirmala Sitharaman finally announced what she claimed was a major stimulus package. Besides some effort to clear blocked housing projects with investment support, the package consisted principally of a set of corporate tax concessions. The corporate tax rate has been reduced from 30 per cent (or an effective rate of 34.61 per cent after surcharge and cess) to 22 per cent (or an effective rate of 25.17 per cent) for domestic companies that do not avail of tax incentives or exemptions. And the minimum alternative tax (MAT) applicable to companies that do avail incentives and exemptions has been reduced from 18.5 per cent to 15 per cent. This is a huge bonanza, which is expected to account for much of the revenue foregone to finance the stimulus, estimated at 1.45 lakh crore or around 0.8 per cent of GDP. That loss comes at a time when corporation tax collections (net of refunds) have risen by just 0.5 per cent over the first seven months of fiscal 2019-20, as compared to a full year growth target of 15.4 per cent.

The tax concessions would undoubtedly increase net profit margins of corporations, but, in the absence of any autonomous revival of demand, are unlikely to spur investment. On the other hand, what they would do is substantially raise the fiscal deficit, unless matched with spending cuts elsewhere. In the first seven months of 2019-20, direct tax collections amounted to Rs.5.2 lakh crore, which was less than two-fifths of the Rs.13.25 lakh crore set for the whole year. This was even before the

effects of the latest round of corporate tax concessions were announced. Not surprisingly, according to reports, the income tax department has approached the government with a request to reduce the target set for direct tax collections by Rs. 1 trillion.

Meanwhile, slowing growth and downward revision of rates for a host of commodities have resulted in GST collections falling dismally short of target. In the previous financial year, 2018-19, as against a target of Rs. 1,12,000 crore a month set in the budget, average GST revenues fell short of Rs. 1 lakh crore a month. While the monthly average in the first seven months of 2019-20, was just above Rs. 1 lakh crore at Rs. 1,00,239 crore, there are signs of a slowing of collections. The figure for September was Rs. 91,916 crore and that for October Rs. 95,380 crore, both of which were lower than the collections in the corresponding months of the previous year. Such revenue shortfalls would imply that expenditure too would be short of target, aggravating the growth slowdown, and depressing collections even further. Holding back on deficit spending seems to be contributing in an widening of the deficit, even as growth decelerates sharply.

The government has already exhausted sources from which it can draw resources to compensate for this revenue shortfall. It has already engineered the enforced transfer of an extraordinarily large Rs. 1.76 trillion from the surpluses of the RBI to the government. Even if it fast-tracks its disinvestment programme it is unlikely to get more than the Rs. 1,05,000 crore it has already budgeted for. So, a reduction in spending relative to budgetary targets, with attendant adverse implications for economic performance, seems inevitable. The real danger is that as preparations for the next budget begin, the government, given its obsession with establishing its fiscal reform credentials, may choose to significantly curtail expenditures further to keep the fiscal deficit in striking distance of the 3.3 per cent target. If that transpires the decline in growth could prove to be sharper. The news that factory output, as measured by the index of industrial production, contracted in September by 4.3 per cent, marking a seven-year low in the annualised month-on-month growth rate, may only be the preamble to a story of India's descent into recession.

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