The Indian economy needs policy protection

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The pace of expansion in the Indian economy once again surprised analysts on the upside. The gross domestic product (GDP) data, released on Friday, showed that the economy grew at 8.2% in the first quarter of the current fiscal. Although this was on a relatively lower base, data suggests that the economy has recovered well from the twin policy shocks of demonetization and the implementation of the goods and services tax (GST).

The growth during the quarter was fairly broad-based. For instance, the agriculture sector expanded by 5.3%, while manufacturing registered a growth of 13.5%. Construction activity expanded by 8.7%. It is also encouraging to see that investment demand is picking up. Higher private sector investment will help improve potential growth. However, the big question is: Can the growth momentum be sustained?

The headline growth is likely to moderate in the second half of the fiscal because of the base effect. Also, there are a number of factors that will require close monitoring and can affect economic outcomes in the coming quarters.

First, financial conditions in the international market are tightening, and the cost of money is likely to go up. Further, the rupee is depreciating, and renewed pressure on emerging market currencies over the last few days indicates that things may not stabilize in a hurry. All this could affect businesses looking to raise capital from international markets. Although the Indian banking system is said to have entered into the final phase of the bad loan problem, it is likely to take some time to stabilize before it begins to fund India's growth. Besides, trade tensions are a big risk for the global economy and can affect growth at a time when India's exports are showing signs of a turnaround. Therefore, in the coming quarters, the external environment may not be as supportive as it has been in recent years.

Second, fiscal constraints may not allow the government to push growth. Last week, for example, Moody's Investors Service highlighted the risk that the Union government might miss the fiscal deficit target. Higher oil prices and relatively higher minimum support prices could push expenditure, while the reduction in GST rates could affect revenues. The Union government is aiming to restrict the fiscal deficit at 3.3% of GDP in the current year. Further, state government finances have worsened in recent years. Although they are looking to reduce the fiscal deficit in the current year, as the Reserve Bank of India (RBI) noted in its annual report, risks could arise from farm loan waivers announced outside budget allocations, and impending elections in several states. Pressure on government finances could lead to a reduction in capital expenditure. However, it is important that government finances be carefully managed and deficit targets maintained, even if this requires sacrificing some amount of growth in the short run. In the given global context, fiscal slippage along with higher current account deficit could affect market sentiment and increase risks to macroeconomic stability. Sustained pressure on capital flows will impede investment revival and affect growth in the medium term.

Third, further monetary policy tightening could be in store. Although the monetary policy committee (MPC) of RBI has raised rates pre-emptively, a pick-up in economic activity can increase the risk of higher core inflation getting generalized. Thus, the dilemma for the MPC in the October meeting will be whether it should wait and see the effect of its past policy action or move forward with another hike to contain aggregate demand. Capacity utilization is increasing, which will give firms more pricing power, and the MPC believes that the output gap is virtually closed.

However, this is not the only risk. The pressure in the currency market might also warrant a monetary policy response. The MPC has maintained that the policy is determined only by the inflation-targeting mandate and a rate hike may be needed even to avoid inflationary consequences of depreciation in rupee. If the MPC decides to leave the rates unchanged in the October meeting, it will have to wait till December to make its next move, as an out-of-turn rate action will affect market

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confidence. Things will become clear in the coming weeks, but further policy tightening cannot be ruled out at this stage. Therefore, despite the positive surprise, growth numbers should be interpreted with care, as the given macroeconomic situation, particularly on the international front could pose challenges. The situation requires policymakers to remain vigilant and preserve macroeconomic stability. A significant increase in currency market volatility can dent market confidence and affect investment decisions.

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