In Search of a New Industrial Stimulus*

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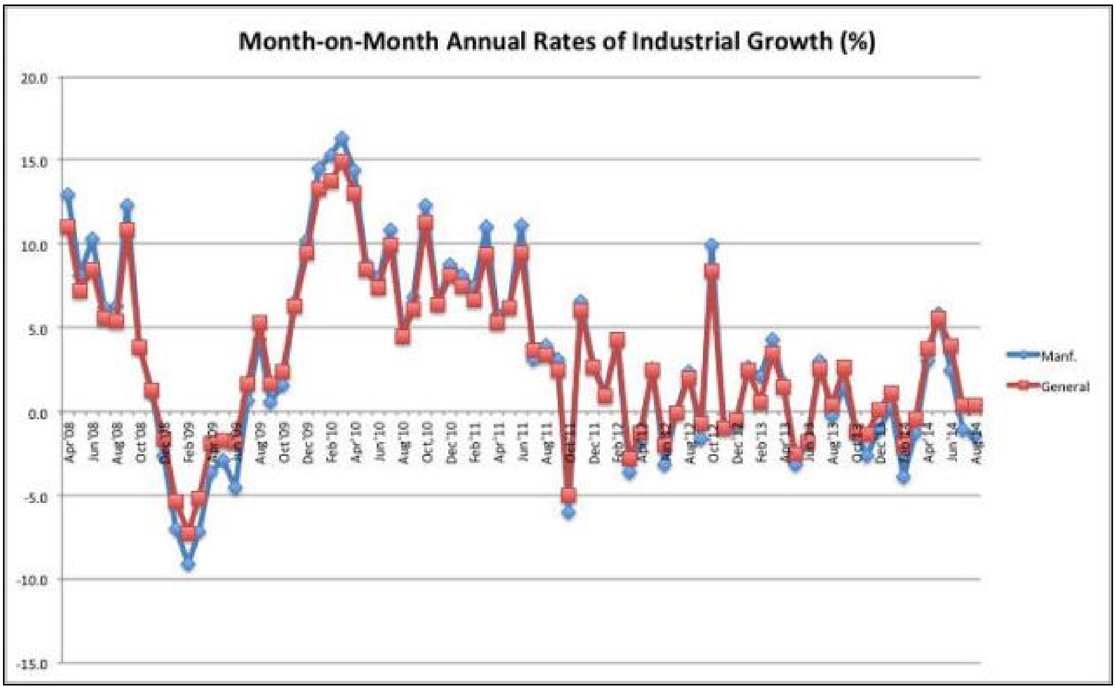
On a month-on-month basis industrial growth in August this year (as measured by the Index of Industrial Production) was just 0.4 per cent relative to August 2013 reports the Central Statistical Organisation. Performance in a single month based on provisional figures may not be an appropriate basis for judgement. But if we take the period April-August, or the first five months of the current financial year, then growth during the period in 2014-15 was at 2.8 per cent by no means creditable. The performance of manufacturing alone was even worse, just touching 1.8 per cent. The picture is one of persistence of the slow industrial growth experienced during the previous year.

Thus, while there seems to be a degree of optimism based on GDP statistics, buoyed further by speculation that the new government would make a difference, the lead indicator of growth in the manufacturing sector does not support that. This is in fact a long-term tendency. As the accompanying Chart shows, Indian manufacturing recorded a smart recovery months after it began feeling the effects of the global financial crisis in 2008-09, led by the fiscal stimulus that the government provided. But once that stimulus was withdrawn, it experienced a downturn starting March 2010, and has since been recording relatively poor growth rates by historical standards. In fact, month-on-month growth rates have been negative for 17 of the 37 months since August 2011.



While poor export performance may explain a small part of this near stagnation, the onus must finally rest on domestic demand, which has for long been the principal stimulus to growth in India. Simple arithmetic would say there are two kinds of combinations into which domestic demand can be broken up: consumption and investment; and in the case of each of these and, therefore, both together, public and private demand. A feature of the "economic reform" that Indian governments have pursued with differing degrees of earnestness since the mid-1980s has been that public expenditure, or the total of government consumption and investment, has been substantially restrained. The reasons are obvious. The post-reform policy environment favoured incentivising private initiative and required tax forbearance. And the notion of macroeconomic “balance” that the reform-induced openness to international finance implied was budgetary balance in the long-term and fiscal consolidation in the form of a reduction in the fiscal deficit in the immediate future. If tax revenues are sticky and the deficit under control, the ratio of public expenditure to GDP must necessarily be characterised by a downside bias and prone to decline.

The result is that there are constraints on aggregate spending on government consumption and investment. Government “consumption” expenditure, however, is sticky downwards because two important components of it—interest payments and the wage salary bill—are not easily curtailed. The interest burden is the result of past borrowing and therefore committed. And trimming government employment and the associated wage and salary bill requires time. The result is that aggregate expenditure reduction is dependent on initiatives such as reductions in welfare expenditures or curbs on public investment. The fiscal reform effort ends up justifying the reliance on private initiative and investment.

There is strong evidence, however, that private investment is induced by, and therefore depends on, public expenditure in general and public investment in particular. Government expenditure not only directly generates demand for privately produced and provided goods and services, but indirectly generates demand for them through the wage and salary bill that it finances. And public investment not only does this, but also facilitates private investment from the supply side by expanding infrastructure and other sectors with economy-wide externalities. So the long-term tendency for public expenditure decline under neoliberal reform erodes the inducement to investment in the private sector as a result of tax forbearance and fiscal conservatism.

What then drove Indian industrial growth during the years between 2003 and 2008 when growth was high, despite the pursuit of policies of reform? What substituted for public expenditure to sustain demand and induce investment? The answer to those questions possibly lies in a distinguishing feature of this period: the remarkable boom in the volume of bank credit. As a ratio of GDP, scheduled bank credit that averaged 20-22 per cent during most of the 1990s, rose to as much as 56 per cent by 2012.

A credit explosion of that kind requires two fundamental supply side influences. First, a change in the ability of banks to lend. And second, an expansion of the universe of borrowers to which banks are willing to lend. The first of course was a result of changes in monetary policy that accompanied reform. While advocates of reform suggest that in terms of monetary policy its objectives are to ensure the independence of the central bank from the government and to make inflation targeting the principal motivation of the central bank, in practice an overwhelming feature of post-reform monetary policy has been a drive to expand credit-creation by the banking system. By reducing the cash reserve and statutory liquidity ratios, by relaxing rules and guidelines influencing loan provision, and by changing the benchmarks determining bank-performance assessment, banks have been encouraged to unleash their lending appetite.

The explosion in bank lending this has resulted in has been accompanied by a change in the direction of bank lending. An important shift has been an increase in the share of retail lending or personal loans for purposes varying from housing investment to automobile and durable purchases, and education, health and personal expenses. The share of such lending in total has risen from less than 10 per cent of total advances to almost a quarter, in a period when the volume of lending has increased dramatically. A corollary is a rise in the share of borrowers with a higher probability of default in the total.

Second, there has been a remarkable change in the direction of bank lending for "industry", with share of lending to the infrastructural sector —power generation and distribution, roads, ports, civil aviation, etc.—in total lending to industry rising from around 2 per cent in1998 to 32 per cent in 2012. This reflected a major shift in policy since banks do not normally lend to infrastructure, which involves bulky, long maturity and low liquidity loans, while their sources of capital are characterised by short maturities and the guarantee of high liquidity. The change occurs because public sector banks are being pressured by the government to lend to private or public-private partnership projects in the infrastructural sectors that are expected to substitute for declining public investment in the area.

Associated with these trends are important macroeconomic shifts. First, they are premised on a monetary policy stance that permits the huge increase in liquidity that back the credit explosion. Second, they feed into aggregate demand and drive growth by allowing debt-financed private spending on investment and consumption to replace tax or debt-financed public spending as the stimulus for growth. The problem with the latter shift is that it is proving unsustainable, since the agents exploiting the opportunity generated by lax lending are not the ones deriving the benefits in terms of income and profit increases resulting from the debt-financed growth trajectory. In the event many of those agents are finding it increasingly difficult to service the interest and amortisation requirements associated with their debt burden. This has resulted in a rise in the share of non-performing loans in total lending in the banking system as well as an increase in the amount of loans "restructured" under the corporate debt restructuring (CDR) scheme introduced after reform. Involving maturity extensions, reduced interest rates, substitution of debt with equity and additional debt provision, these CDR agreements most often merely postpone default and conceal doubtful debt as restructured "standard" advances.

So long as the credit explosion could be sustained so could a temporary boom in industrial growth that had earlier slipped because of the erosion of the stimulus derived from public spending. But as defaults rise and impose restraints on both lenders and borrowers this stimulus too is waning. Meanwhile, as the first budget of the new NDA government made clear, it too is unwilling to alienate international financial investors and the credit rating agencies speaking for them, by choosing a proactive fiscal policy with higher taxation and/or a higher fiscal deficit. In the event, the possibility of a revival of a domestic market driven stimulus to industrial investment and growth seems remote. Perhaps this is why Prime Minister Modi is seeking a foreign-investment-led, export-market driven process of industrial growth in the form of his "Make in India" slogan. The slogan may be new, but the idea is old. No reason to believe that a new label can deliver the success that has been thus far elusive.

*** This article was originally published in The Hindu on 17 October 2014.**