

# A cycle of low growth, higher inflation

Unless policy action ensures higher demand and growth, India will continue on the path of a K-shaped recovery



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In recent times, right-leaning economists have been arguing that the Government does not need to do anything with the economy and that it will revive by itself. They call those who disagree with them, doomsday merchants. These economists reason that, like after the Great Depression, the economy rebounded worldwide, and so will it with us. The argument is fallacious on four accounts:

The first factor, demand. In the case of the Great Depression, demand was created by the Second World War effort. Especially in the United States, which was largely spared of the destruction, its industrial capabilities could be used as a supply base for the entire Allied effort. In the current scenario, there is no war to create demand. On top of it, the COVID-19 pandemic has resulted in demand destruction. This is because many jobs have been lost, and even where jobs were retained, there have been pay cuts. Both of these trends were confirmed in the Centre for Monitoring Indian Economy and other surveys. The only bright spot in this dismal scenario is that the western world has spent a lot of money stimulating the economy. From the point of view of the Indian exporter, rising freight costs and non-availability of containers is a significant impediment along with structural issues such as a strong rupee relative to major

competitors. Only the Indian IT sector is placed well to capitalise on rising demand in the world markets.

Next is inflation. India is suffering from stagnant growth to low growth in the last two quarters. At best, any growth in the current quarter will be illusionary because it comes on top of substantial negative growth in the first quarter of last year, perpetuating a statistical phenomenon known as the “low base effect”. The base effect states that when measuring YoY, or year-over-year growth, we take the previous year’s numbers as the base and measure the growth as a percentage. As in the low initial base set by last year, almost any growth this year is seen as a significant growth percentage. In comparison, the absolute growth figure is negligible. This scenario is eerily similar to the early 1970s in the United Kingdom and the United States, where low growth was combined with rising inflation.

## Causes in India

Inflation in India is being imported through a combination of high commodity prices and high asset price inflation caused by ultra-loose monetary policy followed across the globe. Foreign portfolio investors have directed a portion of the liquidity towards our markets. Compared to a developed capital market such as that of the U.S., India has a relatively low market capitalisation. It, therefore, cannot absorb the enormous capital inflow without asset prices inflating. This might be seen as a welcome move, but it is to be noted that most of India’s population do not own equity or bonds, which means that they cannot cash in on asset inflation. The



wealthy upper class gets richer due to access to financial assets. The middle and lower-middle-class get destitute due to regressive indirect taxes and high inflation, with their wealth eroding due to said inflation. Especially in the case of the lower middle class, inflation is lethal as they do not have access to any hard assets, including the most fundamental hard asset, gold.

## Fuel prices

Additionally, supply chain bottlenecks have contributed to the inflation we see in India today. Essential goods have increased in cost due to scarce supply because of these bottlenecks caused by COVID-19 and its reactionary measures enforced. India’s usurious taxation policy on fuel has made things worse. Rising fuel prices percolate into the economy by increasing costs for transport. Furthermore, the increase in fuel prices will also lead to a rise in wages demanded as the monthly expense of the general public increases. This leads to the dangerous cycle of inflation and depleting growth.

The Reserve Bank of India (RBI) has chosen to look the other way, claiming that this inflation is transitory in nature while inflationary expenses are entrenched. Inflation is here to stay because the RBI

is infusing massive liquidity into the system by following an expansionary monetary policy through the G-SAP, or Government Securities Acquisition Programme. This is designed to keep the interest rates of government bonds at 6.0% and thereabouts. An added threat of rising rates is the crowding out of the private sector, which corporates are threatening to do by deleveraging their balance sheets and not investing.

The third is interest rates. The only solution for any central banker once he realises that inflation is entrenched is tightening liquidity and further pushing the cost of money. If this does not dampen inflation, repo rates will need to go up later this year or early next year. Tightening the money supply is a painful act that will threaten to decimate what is left of our economy. Rising interest rates lead to a decrease in aggregate demand in a country, which affects the GDP. There is less spending by consumers and investments by corporates.

## On NPAs

Finally, rising non performing assets, or NPAs. Rising interest rates, lack of liquidity, and offering credit to leveraged companies instead of direct subsidies to support small and medium-sized enterprises (SMEs) and micro, small and medium enterprises (MSMEs) to counter the COVID-19 pandemic and its effects will result in NPAs of public sector banks climbing faster. Our small and medium scale sector is facing a Minsky moment. The Minsky moment, coined by the economist Hyman Minsky, states that every credit cycle has three distinct stages. The first stage is that of cautious lending

and risk aversion by the bankers. The second stage is lending to trustworthy debtors who can pay the principal and its interest. The third stage is a state of euphoria caused by rising asset prices where bankers lend to debtors regardless of their ability to pay back interest, let alone the principal.

## Minsky moment

The Minsky moment marks the decline of asset prices, causing mass panic and the inability of debtors to pay their interest and principal. India has reached its Minsky moment. This means that the public sector unit and several other banks will need capital in copious amounts to make up for bad debt. Several banks and financial institutions have collapsed in the last 18 months in India. The Union government’s Budget is in no position to infuse large amounts of capital. At best, we can expect a piecemeal effort as in the past seven years. As a result of the above causes, credit growth is at a multi-year low of 5.6%. Banks do not want to risk any more loans on their books. This will further dampen demand for real estate and automobiles once the pent-up demand is over. The Indian economy is in a vicious cycle of low growth and higher inflation unless policy action ensures higher demand and growth. In the absence of policy interventions, India will continue on the path of a K-shaped recovery where large corporates with low debt will prosper at the cost of small and medium sectors. This means lower employment as most of the jobs are created by the latter.

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