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Cart Before the Horse?

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The easier option of consumption-led growth may not be best for the Indian economy

Post the global financial crisis, received wisdom has it that while China needs to rejig its growth model away from excessive dependence on investment towards more consumption, India needs to focus more on investment. But eight years after the crisis, what we are seeing is more of the same.

According to Singapore-based financial markets consultant Anantha Nageswaran, the rebalancing from investment to consumption-led growth that the Chinese leadership vouchsafed in the aftermath of the crisis has not happened. Instead, loans to the property sector are driving economic growth in China.

A Pinch of Ajinomoto

Given how little the outside world really knows about developments in China, any statement about Chinese growth must be taken with a pinch of salt. Nonetheless, the reality is China has shown a unique ability to tide over crises, and by that logic, it should be able to tide over the next one too. The same cannot be said with equal vigour about India. Not only are we much poorer the average Chinese is four times richer than the average Indian but the difference in our political systems and the underlying tensions in our social fabric raises stakes much higher. Hence the need to pause and reflect on the wisdom of pinning our hopes on a consumption rather than an investment led model of growth as a means to sustained, higher economic growth.

What is the difference and why is it important? Consumption-led growth relies on higher consumer spending via the Seventh Pay Commission largesse and one

rank, one pension payout, for instance to raise aggregate demand and lead to higher investment and faster economic growth. Investment-led growth, in contrast, relies on investment to create new capacity. This, in turn, creates more employment and hence higher demand, while simultaneously, increasing productive capacity . As supply rises in tandem with higher demand, growth picks up.

That's in theory. In practice, things may turn out a bit different. But both in India as well as globally , experience has shown that in the long term, economic growth is likely to be higher and more sustained if it is investment rather than consumption led. In the short term, moreover, consumption-led demand could result in an increase in imports (in response to higher demand) and, possibly, a higher current account deficit as well.

In the long term, it could also lead to inflation, unless there is sufficient spare capacity in sectors where there is more demand or where investment has created additional capacity. Else, as economic recovery begins, demand pressures from rising incomes and the sudden release of pent up demand could, in the absence of an adequate supply response, lead to overheating of the economy and inflation. As we in India discovered to our cost earlier when we tried to put the cart before the horse.

The trick, therefore, is to ensure that supply rises in tandem with demand -a tall order at best of times. In a large, complex economy, it is in credibly difficult to fine-tune dema nd and supply . While demand increases almost instantaneously in respo nse to higher salaries, for instance, supply increases after some time. Le ads and lags are inevitable.

Banks, Lend Me Your Money

The job of policymakers, therefore, is to keep an eye on both demand and supply-side dynamics to reduce the gap as far as possible (read: ensure investment picks up). Given the go vernment's limited ability to invest in view of its fiscal

compulsions, this means investment must come from corporates. Which in a bank-driven economy like ours means credit must flow from banks to corporates.

And in the absence of term-lend ing institutions like the erstwhile Industrial Development Bank of India (IDBI), to infrastructure as well. It is naïve to expect that corporates will be able to source all their needs from the corporate bond market.

Unfortunately, bank credit data shows most loans going to retail consumers, not corporates. During Ap ril 2015-February 2016, retail loans grew close to 20% while total lending grew at barely 10%. This might keep individual balance sheets in pristine shape but does very little for the macro economy questioning, as State Bank of India chairperson Arundhati Bhattacharya pointed out, the wisdom of the push to retail lending.

With overleveraged corporates, unwilling to invest, and bank credit not forthcoming, gross fixed capital formation has fallen to new lows.From a high of 33% in 2007-08, gross fixed capital formation is now less than 30%. This must be reversed if higher consumption is not to lead to overheating and inflation.

Both government and RBI have a role to play here. Government by facilitating policy and removing bureaucratic hurdles. RBI by ensuring that credit to industry is not hindered by short-sighted directives that could have unintended consequences. Possibly, by also revisiting the advice Prime Minister Manmohan Singh had given D Subbarao when he took over as RBI governor, "[In the RBI], one runs the risk of losing touch with the real world. With your mindspace fully taken up by issues like interest rates, liquidity traps and monetary policy transmission, it is easy to forget that monetary policy is also about reducing hunger and malnutrition, putting children in school, creating jobs, building roads and bridges and increasing the productivity of our farms and firms." Amen.

Government should facilitate policy and remove bureaucratic hurdles, and RBI must ensure that credit to industry is not hindered by short-sighted directives