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Reviving an Economy

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Nowadays, any discussion among economists with an India connection invariably gravitates towards a familiar topic: the slow and painful unraveling of the Indian economic juggernaut. This quarter the inflation rose to 7.35%, far above the 2-6% band targeted by the central bank. Such huge rise in prices limits the future wiggle room for monetary policy. Meanwhile, credit growth remains low, new mounds of bad loans keep hobbling the system, tax revenues are stagnant, consumer spending is slowing, there are few takers for public sector firms on the block, and the fiscal deficit targets keep getting breached many months in advance. Policies that should normally give a big fillip – like the cut in corporate tax rates, or a large infrastructure spending plan announced last month – seem to have barely made a dent. It is as if the economy has decided on an autopilot course down into the ground, and no amount of cajoling and coaxing can bring it back to its senses.

While there are many details that are specific to the Indian system, economists have for long tried to understand better the broader phenomenon of foreboding that grips the economic climate at such times. In fact, the most well-known economist of the last century, John Maynard Keynes, earned his stripes by proposing what was then a radical solution to the depression that was holding back the western economies in the 1920s and 30s. Keynesianism, as his macroeconomic school of thought came to be known, is one of the many prescriptions that economists nowadays bring to the policy table when conjuring up new ways to treat a failing economy. Just like doctors, economists don't always agree on the best course of treatment. However, almost all economists agree that at this stage, all the myriad policy prescriptions have a simple underlying agenda: reviving the flagging expectations of economic agents.

1. Economic Expectations

Come to think of it, the real ingredients of any economic system are the expectations of the agents that volunteer to be a part of it. Economics does not dictate how the manufacturing process should operate, that is the subject matter of manufacturing. Neither does economics impose restrictions on the production process, optimizing supply chains is domain of operations. Nor does economics lay down strictures on how products must be marketed, or for that matter, how people must consume the multitude of goods and services that are peddled to them. What economics does, however, is to provide a template for the coordination of these disparate enterprises – manufacturing, production, marketing, consumption, and a host of other activities – that brings everything together and then moves it all forward in the best possible way. A manufacturer tries to figure out the how much to make by using the economic marketplace that allows him to gauge the strength of the demand. The consumer tries to determine the best price to pay by using the economic marketplace that allows her to gauge how much other rival sellers might charge. And so on and so forth. No individual economic agent knows for sure what the actual outcomes will be tomorrow, but by gauging the expectations of others in the system, all agents have a much better sense of what the tomorrow holds for them collectively. The crucial function of the economy is this synchronization, and the actual objects that are being synchronized are expectations of agents in the economy.

In a modern market economy, different marketplaces throw up prices for a diverse array of goods and services. You have price of onions, price of cars, price of homes, price of electricity, price for the cable and internet, price of medicine, and even price of entertainment in the form of a tickets at movie and concert halls. The price of any asset, whether it is a physical object or an intangible service, is the value that a buyer hopes to derive from its possession in the future. This value is all about expectations, because the future is yet to unfold when the transaction is sealed. Different people may expect to derive different value from possession, or they may expect the future to unfold differently—thus they bargain and trade. In the end, though, what they are negotiating about, is competing versions of expectations about the future that is inbuilt into the price. Thus, in a very concrete sense, a market system generates the best expectations of its agents for the future.

By this token, when an economy begins to disappoint, it fails because its agents expect it to fail. The actual failure is a consequence of the expectation of failure among the agents.

2. Managing Expectations

Running a modern market economy well is really an exercise in managing diverse expectations. While the functioning of the actual economic machinery is an important component of this exercise, what is equally crucial—but often overlooked—is the careful calibration of expectations of the participating agents in the economic system. In a way, economic expectations are self-fulfilling. If agents believe that the economy is on a

downward trend, they cut back on their investments, and this in turn pushes the economy further down south. On the other hand, if agents believe that the economy is doing well, they spend and consume more, and this in turn boosts the economy. This is the reason top economic managers in a country need to have strong credibility with markets—the markets need to believe in the pronouncements of the economic managers for the pronouncements to have actual effect on the ground.

Building credibility with markets is a long and arduous exercise. Markets need to be convinced that the economic managers know what they are saying, and further, that pronouncements made on paper will be backed by concrete action in the field. This is where reputation matters. For years the Turkish Central bank has been trying to bring its inflation under control through raising interest rates. However, the political leadership in the country has been at loggerheads with the Central bank, insisting on low interest rates to boost growth. The markets think the political leadership is more powerful than the economic leadership in setting the agenda in Turkey, so any pronouncement on interest rates by the Central bank is taken with a huge grain of salt, leading to limited effect on inflation expectations.

In India, too, there is a complicated relationship between economic and political imperatives. On the one hand the economic managers are urged to fight the menace of bad loans, on the other hand political leaders compete with each other in forgiving massive farm loans. On the one hand economic managers try to get bankruptcy proceedings done quickly, on the other hand legal challenges to the process drag on in courts for years. On the one hand the Central bank is promised a free run in its domain, on the other hand through periodic appointments and strictures, its powers are circumscribed. In the past, the Planning Commission was intimately involved in management of the economy and disbursement of central funds, thus announcements by the Commission were a credible signal. Its successor, the NITI Aayog is only an advisory body—their suggestions often overlooked—thus, the Aayog's proclamations carry limited credibility for markets. In other words, there seem to be very few sources for credible forward-looking signals in the Indian establishment today. This is one reason why forward-looking policy guidelines, that should normally give a fillip, are having little effect on the Indian economy.

3. Reviving Credibility

For reviving an economy that is faltering, the first step is to establish credibility with the markets. When this happens, agent expectations can be altered easily through forward-looking policy announcements, and this sets in motion a virtuous cycle that lifts activity economic activity. In fact, not just the economy, this maxim holds true in other domains, too. For a long time, Indian elections were a murky affair, till T. N. Seshan introduced and implemented a series of electoral reforms. More than the actual reforms, what mattered was the credibility that this exercise established for election commissioners. If the commissioners made an announcement, it got deviant

candidates worried, and they therefore desisted from going against the expected norm. In effect, a virtuous cycle was put in motion, the benefits of which Indians are reaping even today.

Keynes was among the first economists to realize the potency of credibility and expectations. The Bretton Woods agreement that he engineered was as much about expectations as it was about actual policy. By getting the governments to commit themselves to far-ranging reform, and bringing in well-known policy makers to helm economic activity, the agreement provided a credible template for sustainable economic recovery after the Second World War as India battles its own economic demons, hopefully the powers that be will heed the lessons of credibility and expectations.

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