Is the Indian economy really that strong?

The Indian economy is currently growing at about 7%, after dipping below 6% following demonetisation. It is projected to grow over 7% this year. That is faster than China's growth rate and makes India effectively the fastest-growing economy in the world.

The Indian economy's foundations have also been strengthened in the last few years. Inflation has come down to the 4-5% range. Trade balances with the rest of the world have improved, and the current account deficit has come down to about 1.5% of GDP. India has also systematically built up its foreign exchange reserves — now a comfortable $420 billion.

These figures appear to tell the story of a dynamic economy. But is it truly that rosy a picture? Deeper analysis indicates that growth may be overstated and the economy prone to significant vulnerabilities.

In order for growth to be both high and sustainable, investment has to be strong. Investment is the act of adding to our productive capacity — building infrastructure, factories, and enhancing the skill of the workforce. However, the striking fact about India is the weakness in investment, reflected in the sharp decline in the rate of investment in recent years. The rate of investment has come down from 34% of GDP in 2014 to about 30% currently. Compared to earlier years, the decline is even more precipitous: the investment rate is now at the lowest level in about 15 years. A decline in investment of this magnitude is difficult to reconcile with a 7% growth rate. Should investment continue to decline in the future, it would be incompatible with high growth.

The other kink to the strong growth story is the weakness in industrial production. It was growing at around 6% in 2016, but plummeted to 2% by mid-2017 following demonetisation. While there has been a pick-up in industrial production in the fourth quarter of 2017, that is exaggerated in comparison to the last quarter of 2016 when activity literally froze up. That is, it is again difficult to reconcile strong overall growth of the economy with weak industrial performance.

Bank financing is important for growth in India. This is particularly true of small and medium-sized enterprises and parts of the agricultural sector where the bulk of the labour force is employed. When there are stresses in the banking system, growth invariably suffers.

The pace of bank lending has been coming down sharply in the last five years. During 2014-16, bank lending grew at a 10% pace. It is now growing at about 6% following demonetisation. The main reason for the slowdown is the rise in non-performing loans. These have doubled from about 5% of gross loans outstanding in early 2015 to 10% currently, as the Reserve Bank of India (RBI) has forced banks to classify loans stringently. Consequently, banks are now more hesitant to lend. This sharp decline in the growth of bank lending is again not compatible with an economy growing at 7%.

If these consistency checks indicate an economy growing at much less than 7%, does it imply that the published growth numbers are made up? I do not believe that the growth numbers are being tampered with to show a strong performance. Our statisticians are doing an honest job in compiling what is clearly a difficult job of calculating GDP.

However, initial estimates of growth are calculated from the more timely data on the formal corporate sector. The economic growth numbers invariably get revised over the subsequent year or two when less timely data from the informal sector become fully available. Demonetisation and the introduction of the Goods and Services Tax, which is a long-term positive for the Indian economy, had far greater adverse effects on the informal rather than the formal sector. Therefore, the initial growth figures, calculated mainly from estimates of the performance of the formal sector, tend to inflate the figures of overall growth of the economy. These will no doubt be revised down in due course. The main point of the consistency checks is to emphasise the need for caution before getting triumphalist about growth. Demonetisation has paradoxically shown initial growth estimates to be higher rather than lower.

As noted above, there have been improvements in the foundations of the Indian economy through declining inflation, improving trade performance, and strengthening foreign exchange reserves. Moreover, despite the electoral cycles, Central government budget deficits have been broadly under control.

However, the improving fundamentals are on slippery ground. While policy measures have helped control inflation, the decline in inflation has largely been driven by extraneous factors. Food and energy prices are important components of the consumer price index and the decline in commodity prices has had a large role in bringing inflation down. Should food and energy prices revert to an increase in the future, it would be difficult for the RBI through its monetary policy actions to bring inflation under control.

Oil, gold and coal constitute almost 50% of total imports in India. Over the past few years, India's trade has gained significantly from steep declines in the prices of these commodities. Rather than strong exports, India's trade improvement reflects the extraneous factor of declining commodity prices. The trade balances would come under renewed pressure should commodity prices, over which India has little control, turn higher.

Lower oil prices have also benefited the Central government budget through reduced spending on energy-related subsidies. Focus generally tends to be on the Central government budget. However, what is more important is the general government budget — the combined budgets of the Central and State governments. This deficit is still a large 6.5% of GDP. Moreover, India's debt is a relatively high 70% of GDP and, unlike in a number of emerging market economies, it has not really come down in the last five years. The fiscal position in India constitutes a hidden vulnerability.

There have been improvements in the Indian economy in recent years. However, the current published growth rate exaggerates underlying strength. The improving fundamentals owe more to favourable external circumstances than to hard domestic policy choices.

Ramana Ramaswamy is Distinguished Academic Visitor at Queens' College, Cambridge