The spectre of deflation

The second volume of the Economic Survey was presented on the last day of the monsoon session of Parliament on 11 August, preventing Parliament from holding a discussion on the state of the economy as outlined by the report.

The second instalment, a departure from past practice, was necessitated by the shifting of the budget presentation to 1 February. But it was also necessary given the lack of available data on the economy, more so given the uncertainty surrounding the demonetization exercise of November-December.

Since then, the spectre of demonetization seems to have faded but the uncertainty created by the goods and services tax (GST) is still looming on the economy. Both demonetization and GST have been shocks to the economy, the impact of which will take time to unravel in an economy already struggling with low investment, low credit, low exports and low demand.

Given all these, the Economic Survey has been candid in its assessment of not just what happened in the last fiscal year but more in terms of what is likely to happen in the future. A quick reading of the assessment in the Survey does not provide a very optimistic picture of the economy despite claims to the contrary by government officials. While the Survey has been cautious in calling out an impending crisis in the economy, it does raise questions on the sustainability of economic growth give the spectre of deflation looming large.

But how serious is the deflationary spectre? Going by the analysis, it does appear real. And it is not just the low inflation reported in June which confirms a declining demand but also the macro fundamentals of the economy which belie any optimism of 7%-plus growth. Almost all indicators including gross domestic product, core gross value-added (excluding agriculture and government), the index of industrial production (IIP), credit, investment and capacity utilization point to a deceleration in economic activity. Not surprisingly, the Survey notes that the growth of 7% in the past two years is more of an exception. The Survey has already moderated its growth projections to the lower end of the 6.75-7.5% range predicted in the first volume.

But it is not just the macro indicators which defy the GDP estimates. The evidence on jobs and the agricultural sector are also suggesting a serious problem with the economy. While employment estimates from available sources continue to suggest either a decline in jobs or at best sluggish growth with jobs continuing to elude a majority of the young entering the labour market, the decline in real wages in the last three years is also confirmation of a weak labour market.

A weak agricultural sector has seen output growth revive after back-to-back droughts but has seen vulnerability increase with price fluctuations leading to unrest in the agrarian economy. The continued run of low inflation might assuage the middle class in urban areas but hurts the producers of agricultural commodities. The terms of trade have moved against agriculture since 2013 and continue to do so with increase in food prices lagging behind the rise in non-food prices.

The decline in rural demand may aggravate given the state of the informal economy and declining investments in agriculture. The decline in agriculture since 2014 in real terms has already hurt the agrarian economy. With loan waivers putting pressure on state fiscal resources, it is likely to go down further. The Survey estimates the cost of loan waivers at 0.7% of the economy. But a larger cost would be the declining investment which may make it more vulnerable to weather and price shocks. So is the case with the informal economy which played a stellar role in absorbing labour displaced from the agricultural sector. It has partially recovered from demonetization but is still struggling from the hurried roll-out of GST.

A recent report by the Reserve Bank of India on 2,726 small enterprises shows a decline of 6.9% in the profits of these firms. But even for large firms, the growth in profits was a meagre 2%.

The issue is not just where the economy is but whether it is doing enough to insulate itself from the deflationary spectre that the Survey talks about. While there are no signs of revival of credit growth or private sector investment, the slowdown in manufacturing and construction points to a long-term problem. It will certainly impact the government's effort to create jobs, but short-term impact may be on growth itself. The twin balance sheet problem remains unresolved with reports of worsening bank performance. A large part of the growth last year was driven by public sector spending, which has not only come to a halt but will likely be unsustainable given the fiscal space available to the government.

The challenge for the government would be to revive demand in the economy and create employment before it leads to disaffection among the youth and the poor. The only way to do so would be to revitalize the informal sector, not by taxing it and regulating it but by creating an enabling environment of greater access to credit, market and availability of infrastructure. The Survey has done its job of identifying the challenges to the economy. But success in dealing with the spectre of deflation would depend on the political willingness of the government to walk the talk.

Himanshu is an associate professor at Jawaharlal Nehru University and visiting fellow at Centre de Sciences Humaines, New Delhi.

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