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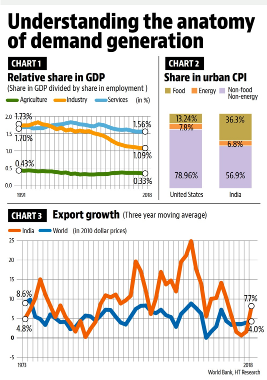
OPINION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

India’s GDP grew at 5.8% in the quarter ending March, 2019, the lowest figure since the 5.3% recorded in the quarter ending March 2014. The GDP growth rate has been coming down continuously since June 2018. A section of academics and commentators, including a former chief economic advisor to the Narendra Modi government, think that the economy is doing worse than what the official statistics tell us. In a paper published last month, Arvind Subramanian argued that official GDP statistics could be overestimating India’s GDP by around 2.5 percentage points. The Prime Minister’s Economic Advisory Council has rejected Subramanian’s arguments in a rejoinder. A final resolution of this debate is not possible unless the government constitutes an independent committee to ascertain the veracity of GDP statistics. The debate on magnitude of the GDP growth rate notwithstanding, both the government and its critiques are in agreement over the fact that the Indian economy is showing unmistakable signs of a slowdown. The question is how does one reverse it? The government, as evident from both Thursday’s Economic Survey and Friday’s Union Budget, believes private investment holds the key. That may well be the case. Still, any credible answer to this has to look at the GDP as a sum of parts and the relative weight of these at a given point in time. Here’s why.

Elementary economics tells us that there are two ways to look at what constitutes the GDP of a country. The first is a sector-wise approach, with agriculture, industry and services being its three major components. The overall GDP growth is a weighted average of share of each sector in the economy and their respective growth rates. The second is an expenditure/ demand classification, with consumption (private and government), investment and net exports as the three major components. While each of these sub-categories matter for present growth, investment is a crucial determinant for future growth as well.



As an economy gets modernised -- economic transformation in economics jargon -- the share of agriculture in GDP comes down and that of industry and services increases. A change in sector-wise distribution of GDP, however, is no guarantee of the same for income distribution in an economy. This depends on the share of employment in different sectors of the economy. An example can make it clear. Let us assume that the total GDP of a country in a given year is ~100 with the share of agriculture, industry and services being ~20, ~35 and ~45 respectively. Now, let us assume two different scenarios for the employment share of these sectors. If the employment share of each of these sectors were the same as their GDP share, then the GDP would be equally distributed in the economy. If there were 100 workers in the economy, and all workers in a sector made the same amount of money, then everyone would earn one rupee in this case. Things would be radically different if the employment-income shares of sectors are different. Let us assume that agriculture had half of the workers, while industry and services had a 40% and 10% share in employment. In this case, 50 workers in agriculture would earn 40 paisa each, 40 workers in industry

would earn 87 paisa each and the 10 workers employed in services would make Rs 4.5 each. To be sure, a real economy can never have same levels of earnings for all workers in a sector too. For example a CEO, a freshly hired engineer and a porter in a car manufacturing company would have very different earnings.

The Indian economy, for a long time, has been closer to the second example discussed here. Even as the share of agriculture in GDP has come down from 27.3% in 1991 to 14.5% in 2018, its share in employment has been relatively stagnant, having come down from 63% to 44% during this period..

This has basically meant that a large number of workers engaged in agriculture in the Indian economy have much less incomes, and hence purchasing power, than their peers engaged in nonagricultural activities. Why should distribution of purchasing power concern a discussion on economic growth?

It matters because purchasing power is an important determinant of how much of what is sold, and, to a large extent, produced in an economy. For instance, India's benchmark inflation measure, Consumer Price Index (CPI) assigns a much higher weightage to food items than that of a developed country such as the US. Inflation indices are representative of the average demand from a household in an economy. This means that nonfood items have a more broad-based demand, and hence market, in the US than in India.

The higher share of food items in average demand is also a reflection of lower overall incomes in an economy. As is to be expected, the potential for value addition (income generation) in food items is much less than non-food items. This means that an economy where food items have a greater share in average spending will be making more of low value addition goods than an economy with a higher share of average non-food demand. For an economy like India, a big boost in demand for non-food items, especially of the high value kind, can generate big tailwinds for overall GDP growth by increasing their production. It is for this reason that developments such as deceleration in automobile sales, which has what has been happening in India in the recent period, are seen with concern -- they hit production in high income generating sectors.

The discussion so far allows us to bring our focus to the demand side break-up of GDP. If consumption demand, especially for automobiles rather than food, is slowing then it is a double whammy for GDP growth. This is because it affects consumption demand in the current period and investment demand in the future. Investment demand is adversely affected because an entrepreneur, who is not being able to sell even current output, is unlikely to have, and therefore put more money for increasing or improving production.

To be sure, domestic demand is not the only avenue for GDP growth. A country can always make products and sell them in foreign markets, even if there are no buyers at home. The positive impact of exports on a country's income is offset by imports, which add to another country's demand. However, there are two important limitations to exploiting this as a driver for growth. A country can be import dependent for critical resources such as oil, which can lead to an ever increasing import bill, and hence declining net exports, as incomes increase. India is a good example of this due to its dependence on oil-imports. The other important challenge comes from the nature of the domestic market. Normally, producers first start their businesses in the domestic market and then enter the export markets. Therefore a country which does not have a broad based market for high value products, and hence lack of domestic expertise for manufacturing such products, is unlikely to reap success in exporting such products as well.

This constraint can be navigated when a foreign entrepreneur brings such technical knowhow via the foreign direct investment (FDI) route. This explains why developing economies such as India are always keen on promoting FDI. It also explains why finance minister Niramala Sitharaman said in her budget speech that India would seek to attract technology majors to come in and set up factories to make new-age products such as Electric vehicles, solar equipment and batteries.

The FDI route has its own limitations, though. A big-ticket FDI will only materialise if the investor hopes to capture a big share of the domestic or foreign market. With global growth slowing, demand in foreign markets is likely to lose pace. Global exports have in any case been growing at a slower pace than before the 2008 financial crisis. The slowdown in global export growth post-2008 has affected India disproportionately, which can be seen from the fact that India's export growth has come down significantly after this period. If the slowdown in global exports were to continue, India would continue to face a squeeze on an important driver of economic growth in the near future.

For a country like India, where the domestic market is constrained due to many workers having low incomes, domestic market growth is limited to selected goods. Mobile phones in the recent period are one such example in India. However, not all FDI is an unambiguous blessing. For example, if a Chinese phone manufacturer were to set up its final assembly plant in India, and import most components for making these phones, the net export impact would be limited for the Indian economy. Such an FDI will also kill the possibility of developing indigenous entrepreneurs in these sectors.

The problems listed here are much easier to discuss than solve. Most of these are also similar to what can be termed a vicious cycle. If mass incomes are lower, there won't be enough demand for high value food items, which would restrict domestic production and knowledge creation about producing these and hence prevent the country from becoming a successful exporter of these. It is naive to think that all these issues can all be solved immediately. Politics also plays it part. For example, farmers' incomes would improve if food prices in India were to become higher. But this would mean an extra burden on most other Indians, who spend a large share of their earnings on food.

The key to successful economic transformation lies in having a holistic picture about the challenges facing the economy and then synchronising specific policy responses with the right opportunities for making these interventions.

Back-to-back decisive victories for Narendra Modi have brought an element of continuity for the present regime in the country. This merits that the evaluation of its economic performance should also be done on these long-term parameters rather than just quarterly or even annual economic statistics.

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