Tackling the economic slowdown

“All hat and no cattle” goes the Texan description of posturing without economic heft. The government of Narendra Modi should be prepared to receive such a verdict on its economic policy if things continue to go the way they are right now. Economic growth has slowed for five consecutive quarters, that is from late 2015-16 onwards. By now growth is slower than it was in the quarter in which it assumed office. For a government that had promised to turn around the economy through decisive governance, this must serve as a wake-up call.

Economic slowdown is real, not just technical: SBI Research

Why should it matter to us if the economy is growing more slowly? Growth matters in India as a large number of persons have to make do with far too few goods and services as it is, which is how poverty is defined. Note that these goods also include public goods or goods that are accessed by the entire populace of a country, such as parks, roads and bridges. Since these public goods are provided by government, the government needs tax revenues to supply them, and these depend upon national income. Then there is employment. A demand for labour exists only when there is a demand for goods. So growth is necessary if employment is to be assured.

In India we not only have a pool of unemployed persons to absorb but we also need to provide employment to youth continuously entering the labour force. From this point of view, the slowing of the economy is a source of concern. An economy that has been slowing for five quarters is unlikely to turn around quickly. Also, it may not be able to do so on its own.

Replying to the suggestion made that the economy needs a shot in the arm in the form of a fiscal stimulus, the government’s spokespersons have responded by saying that it is working on ‘transforming’ the economy, and that its policies will have long-term favourable consequences. Its transformative approach may be expected to fructify only with a lag, we are told. While the government itself has not ruled out expansionary macroeconomic policy, writers in the media, including an editorial in this newspaper, have poured cold water on the very proposal, championing instead structural reforms. This challenge must be met.

The first thing that comes to mind when ‘more structural reforms’ is proposed is that reforming is what all governments have been claiming to do for more or less a quarter of a century now. Since 2014, in particular, “the ease of doing business” has received great attention from this government. The economy today is far less regulated than it was in 1991. It would be correct to say that labour market reforms have not been taken up yet in Parliament and that exit is necessary for a dynamic economy. Labour laws in India make exit difficult, and complying with requirements with respect to the hiring of labour is time consuming and therefore costly. It is possible that the share of manufacturing will rise if the labour market is liberalised. And, though only a one-time gain, this could even benefit labour. However, it is not clear how this relates to the situation today which is one of slowing growth.

India’s economic growth may slow down, says IMF

It is when it comes to the land market that the argument for more reforms is least obvious. Apart from restrictions on conversion of agricultural land, no policy stands in the way of private parties transacting with one another. Surely, we can’t treat the issue of the alienation of agricultural land so casually as to remove all discretion vesting with government. If the argument is that the government must ensure as much land to private industry as they seek, though at a price, this is an intervention out of sync with a market economy. In this context, it may be said that an intervention that government in India should avoid is facilitating land acquired for industry to be alienated from manufacturing activity. Cases in question range from land owned by public sector units in Bengaluru, private mills in Mumbai and private industry in rural Kerala.

For credibility, the argument made for land and labour market reforms as a pre-requisite for accelerating growth today must be able to account for how the economy came close to achieving 10% growth in the late 1980s and during 2003-08 when the policy regime was no more liberal than it is now. Equally, it would be difficult to relate slowing domestic growth to sluggish world trade as data show 2016-17 to be a year of a major turnaround in exports. On the other hand, capital formation as a share of output has declined almost steadily for six years now. In 2014-15 it rose slightly, as if in cue to Mr. Modi’s arrival, but soon resumed its sliding at a faster rate. The government appears to make light of this development. Actually, it contributed to the downward trend by reversing the rate of growth of expansion of public capital formation from 2015-16.

It is generally the case that it is capital formation, or investment, that drives growth in the economy. Investment is an immediate source of demand as firms that invest buy goods and services to do so, but it also expands the economy’s capacity to produce. Of the two sources of investment, namely private and public, the first has been depressed for some years. In a slowing economy, private investment is unlikely to revive in the absence of some external force. This is so as investment involves committing funds for a long period under uncertainty. It is for this reason that economic theory prescribes the stepping-up of public investment when private firms are unwilling to invest more. Not only does increased public investment increase demand and quicken growth but it may be expected to encourage private investors, as the market for their goods expands.

Other things being the same, increased public investment leads to a higher deficit, which is the gap between the government’s expenditure and its receipts. Among economists themselves there is resistance to governments running a deficit for fear that it may be inflationary. But in any such assessment, the increase in inflation must be offset with the increase in growth that would have been achieved due to greater public investment. In India, the increase in inflation that could come with higher growth would be due to the shortage of agricultural goods. So any plan for increasing the rate of growth, not just at the present moment but in general, must reckon with agricultural shortages. We have not yet fully solved this problem in India, whichever the party at the Centre.

The government is urged by some to refrain from increasing the deficit. While it is right to be concerned with the consequences, the correct approach would be to aim to balance the budget over the growth cycle. That is, the deficit may be increased as the economy slows and contracted as the economy quickens. To object to an increase in the deficit irrespective of the state of the economy is to be dogmatic. Since 2014 the government has focussed aggressively on the supply side by making it easier for private firms to produce. But we are now facing a demand shortage in the economy. The immediate thing to do is to expand public investment in infrastructure. The argument found in the media that there are “no shovel ready projects” is to encourage lazy governance. Repair and reconstruction of India’s creaking infrastructure is the direction in which greater public investment must now flow. It is the most direct and potent measure that can be undertaken to address the slowdown the economy is experiencing.

Pulapre Balakrishnan is Professor of Economics, Ashoka University, Sonipat, Haryana and Senior Fellow, IIM, Kozhikode, Kerala

END