Economy outlook still cloudy

The government's move this past week to publish economic data for the April to June quarter of this year needs a look. The real growth of GDP, i.e. after removing the impact of inflation, was only 5.7%, much lower than expected. For the past six consecutive quarters, the growth rate has gone down steadily, from 9.2% at the end of the quarter ending March 2016, to 7.9%, 7.5%, 7.0%, 6.1% and now 5.7% at the end of the June quarter.

This steady declining trend in the growth rate is all the more troublesome because the economy otherwise enjoys a rather conducive combination of macroeconomic parameters. Inflation has been moderate, and touched a low of 1.5% recently. Both trade and fiscal deficits are moderate and manageable. So they don't eat up investible resources or precious foreign exchange. Even the interest rate has been cut repeatedly over the past year and a half. The inward rush of dollars is at a peak, both in financial markets (stocks and bonds) and as direct investment. No wonder the stock market index is at an all-time high. Even oil prices, the bane of the Indian economy, have been stable and comfortably low. Finally, the monsoon has been normal. So despite these favourable macro factors, we have not managed to convert them into a higher growth rate.

As cautioned in the Economic Survey tabled recently in Parliament, it looks as if the growth rate will be below 7% this fiscal year. That would be a potential loss of 1% growth, which we can legitimately aspire for. In nominal terms, one percentage less of growth translates into a loss of 1.5 lakh crore of national income. This is a notional loss, or is rather what might have been. It also signifies millions of jobs not created.

If you look closer at the numbers, you find that manufacturing growth at 1.2% is the lowest in the past five years. It's the lowest since we switched to a new methodology (based on Gross Value Added). Some of this downward movement was caused supposedly by the suspension of manufacturing activity prior to the rollout of the Goods and Services Tax (GST) in July, and consequent de-stocking of inventory. But it is also corroborated by data from commercial banks. From April to August bank credit shrank by 1.8%, i.e. negative growth. This is the lowest it has been for at least 13 years. If you remove retail loans such as housing and other personal loans, credit to industry might actually be shrinking. This was flagged back in April also when the annual credit flow from banking for the previous fiscal year clocked a multi-decadal low. A State Bank of India report said that credit growth for the year ending last March was the lowest in 63 years!

The GDP is measured in at least two different ways. The first is by looking at the production side while the second is by looking at the spending side. We look at the aggregate of all spending, whether on consumption, or by foreigners buying our exports, or on investments into new factories and projects. In addition we also have government spending. The growth in GDP can be traced to the growth and vigour of each of these components. Investment, which is between 30 and 35% of the total pie, needs to grow at least in double digits. Investment in future capacity creates GDP growth of the future. It needs to be led by the private sector. Currently, that component is barely growing at 1.5%. This is the single most telling metric. As a result, capital formation (the basis of future growth) is steadily declining for several years. Private sector investment has practically come to a standstill. Despite the push for 'Make in India', reforms for improving 'Ease of Doing Business', increased access to electricity, improvement in infrastructure and private investment are not picking up. This must become the big priority. Initiatives such as Housing For All, Smart Cities and Digital India give room for huge opportunities for private entrepreneurs. Of course the corporate sector and banks have been affected by the twin balance sheet squeeze wherein corporates are over-leveraged, and banks have mounting bad loans. Whether the new insolvency code and regulator and the Reserve Bank of India's aggressive intervention will crack this puzzle remains to be seen.

Another significant challenge to the domestic industry is the ever-strengthening rupee. Since January the rupee is 7% stronger compared to the American dollar. It is stronger than its Asian peer currencies too, including China, the Philippines, Indonesia and Thailand. This directly hurts our export prospects. Since last October, our export growth has begun showing positive growth, after a long phase of negative growth for 18 months. But thanks to the strong rupee, this trend is weakening. Indeed our exports are barely up 12% since January, whereas imports are up more than 30%.

More importantly, the strong rupee hurts the domestic industry since cheaper imports flood the country and eat into the market share of domestic players. The GST regime has given an extra advantage to importer traders since the countervailing duty that they now pay as GST can be offset against other taxes, a concession which was not available earlier. The big jump in imports is also captured in the June quarter of GDP data, which also show a worrying jump in gold imports, again thanks to a strong rupee. It's no use saying that since India is a net importing country, our exchange rate should be stronger. If we remove gold imports, a large part of which is not for consumption but as store of value, then our trade deficit will be much smaller. Besides most of our other imports are oil or capital goods, both of which are price inelastic. The rupee needs to be weakened or else it will hurt domestic manufacturing even more.

Finally, one must not forget the continuing adverse impact of demonetisation. The first half of the last fiscal year, that is the period prior to demonetisation, recorded a real growth of 7.7%. The present April to June quarter's growth at 5.7% certainly includes the negative impact on the informal and rural economy. Investment and consumption spending which were postponed due to cash shortage might recover. But jobs that are lost are lost forever. Even the Economic Survey warns about the deflationary impact of low agricultural prices. The agriculture sector GDP shows nominal GDP growth to be lower than real GDP, which is very unusual. It means that farmers' incomes will be depressed, and doubling of farm incomes in five years becomes that much more of a distant dream.

Perhaps in the coming quarters we may see a rebound. That will crucially depend on a big pick-up in manufacturing and private investment spending. The big structural reforms of GST, the new insolvency code, the new monetary framework and Aadhaar linkage are measures which will show results in the medium to long term. What we need is an immediate stimulus to re-inject the momentum to get us to 8% growth.

Ajit Ranade is an economist

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