Why is the economy slowing down?

The release of the annual report of the Reserve Bank of India (RBI) and the estimates of economic growth in the first quarter of this year have reignited the debate on the state of the Indian economy. The much-awaited RBI annual report confirmed what many had known for months, that demonetisation has failed to fulfil its stated objectives. While demonetisation certainly hasn't succeeded in fulfilling the objectives for which it was undertaken, it did contribute to the deceleration in economic activity, with the growth rate of gross domestic product (GDP) and gross value added (GVA) reaching their lowest levels since the National Democratic Alliance government took over.

But blaming the economic slowdown only on demonetisation would be missing the wood for the trees. While demonetisation certainly contributed to the deceleration in economic activity, its role was only to accelerate the slowdown of the economy rather than being its primary cause. Most of the core indicators of the economy over a long period suggest that the economy was already slowing down. GVA at basic prices has been declining secularly since the last quarter of 2015-16, reaching its lowest level in the first quarter of this year, much before demonetisation was undertaken. So is the case with exports which have been declining for almost two years now. Same is the case with private investment in the economy which has continued its declining trend for almost two years now. With the worsening balance sheet of the financial sector, credit growth is at its lowest. The manufacturing sector has also been on a downward path for a long period now, along with construction which saw negative growth with some recovery in the previous quarter.

As I have argued earlier, the real problem in the economy is the decline in demand led by the collapse of rural demand since 2014. Some of the signals of a demand crisis in the rural economy were visible as early as late 2014 with the decline in real wages and commodity prices. It has now spilled over to the entire economy with no effort by the government to push demand in rural areas. The government continues to live in denial with all sorts of explanations which belie any understanding of the Indian economy or even the basic theory. The issue of demand deflation was finally highlighted by the second volume of the Economic Survey and has now been confirmed by the estimates of first quarter with agricultural GVA declining from an average of 9% in the four quarters of 2016-17 to 0.3% in the first quarter of 2017-18 at current prices. This has happened in a year when the agricultural sector is recovering from back-to-back droughts in 2014 and 2015. Further confirmation of the decline in demand is available from the decline in share of private expenditure to 57% in the previous quarter from 62% in the third quarter of 2016-17. A sharp decline from a high during the demonetisation quarter when private consumption was already low due to demonetisation.

But the real impact of the demand deflation is on the manufacturing and the construction sector, both of which have seen a sharp deceleration. The growth of manufacturing has been declining quarter-on-quarter since the third quarter of 2015-16, reaching the lowest of 1.2% in the first quarter of 2017-18. Even this has been achieved by a growth of 1.8% of the quasi-corporate and unorganized sector with private corporate sector declining by 0.9%.

Similar is the case of construction, which has recovered from a decline of 3.7% in the last quarter of 2016-17 to 2% in the first quarter of this fiscal. But even this is misleading, with cement production declining by 2.9% and non-metallic minerals declining by 3.2%. The only reason the construction sector has seen a positive growth is due to growth in consumption of finished steel.

The collapse of the manufacturing and construction sector are serious signs of a crisis in the economy since both of these account for a large majority of non-farm jobs in the economy. Clearly,

evidence of job losses is no longer a figment of imagination, but are hard facts. The slow pace of employment creation and declining real wages are sure signs of a demand collapse in the economy.

It is now evident that there are serious problems with the state of the economy and any attempt to brush these as momentary phenomena as a result of demonetisation and goods and services tax (GST) is only going to make it worse. While demonetisation and the hurried rollout of GST did contribute to the worsening of the economic situation, any hopes of the economy reviving on its own as these effects fade out is unlikely to materialize in the short-to-medium term. Growth in the next two quarters is likely to be subdued with agriculture sector not contributing much. With a higher base of 2016-17 and monsoon not very different from last year, agriculture GVA is unlikely to contribute to growth. Much of the growth in the previous quarter also owes itself to significant increase in government spending. But this has also meant that 92.4% of fiscal deficit has been reached by the end of July 2017. With dividend from RBI also declining by half and not much expected from disinvestment, there is not much fiscal space that is available unless the government relaxes the fiscal deficit target of 3.2% of GDP. It is unlikely that government expenditure will provide the same cushion that it did in the previous quarter. If the acceleration in growth of trade is due to destocking due to GST rollout, even the trade sector is unlikely to maintain its growth.

The challenge for the government is to revive the economy with very few options left. It has frittered away the windfall gains from lower petroleum prices which could have been used to increase investment in agriculture and infrastructure. Agricultural investment has declined in real terms and infrastructure investment hasn't picked up given the twin balance sheet problem. But it has also missed the opportunity of injecting demand in the rural economy by expanding public expenditure led employment creation. The revival of funding to the rural job guarantee programme was withdrawn soon after the effects of demonetisation started fading. But the severe cuts in financing of agricultural programmes, rural development, education, nutrition and health also meant that the rural economy continued to suffer from lack of demand and neglect from the government.

It is not, however, too late. But the first task for the government is to acknowledge that the economy is in serious mess. Both in terms of job creation as well as growth prospects. These may turn out to be serious risks to the stability of the government if they persist longer. But these also require that the government may have to give up its fiscal deficit targets in the short run and increase public spending in the rural areas but also in infrastructure and other public services.

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