Time for course correction: on India's declining growth rate

What do the latest numbers on national income indicate? What are the chances of the Indian economy moving out of the current phase of relatively low growth? Or are we stuck at a new 'Hindu' rate of growth?

About a week ago, the Central Statistics Office (CSO) released the estimates of the gross domestic product (GDP) for the first quarter (April-June) of 2017-18. The numbers showed that in **Q1 of 2017-18, GDP grew by 5.7%**. Gross value added (GVA) at basic prices grew by 5.6%. Whichever measure you take, the growth rate has fallen below 6%. In the corresponding quarter of the previous year, GDP grew at 7.9% and GVA at 7.6%. What accounts for the decline in growth rate by almost 2 percentage points? Certainly, demonetisation must have had a negative impact. Also, the destocking of goods which might have happened prior to the introduction of goods and services tax (GST) must have also had a negative impact.

However, it might be inappropriate to attribute the entire decline of 2 percentage points to the two factors. What has been happening is a steady decline from the first quarter of 2016-17 when the growth rate of GVA was 7.6%. By the third quarter of 2016-17, the growth rate had declined to 6.7%. Since then it has fallen by another 0.9 percentage point. Given the growth rate of 5.6% in Q1, it is unlikely that the growth rate for the year as a whole will exceed 6.5%. For this to happen, the growth rate in the next three quarters will have to be 7%. The most disappointing aspect of the first quarter numbers is the steep fall in the growth rate of manufacturing to 1.2%. Because of the good monsoon, agriculture will do better. Since agricultural growth rate last year was also good, the increase may not be that much.

If the economy has to get back to the high growth rate seen earlier, we need to understand the factors that might have been operating to bring down the growth rate.

Why India's GDP growth is falling?

One of the arguments attributed to the low growth rate is the poor performance of the external sector. Growth is fuelled broadly by two types of demand, domestic and external. High export growth has propelled the growth rate of many countries, including China's. In India's own experience, the high growth phase between 2005-06 and 2007-08 saw exports growing at an average annual rate exceeding 20%.

India's declining growth rate has also coincided with poor export performance. Export demand has been weak because of the tepid growth rate of the advanced economies. Both in 2014-15 and 2015-16, the export growth rate was negative. However, the export growth rate has become positive since the second half of 2016-17. While undoubtedly export demand is critically important to sustain high growth, the sharp decline in growth rate noted in the last few quarters cannot be attributed to poor export performance. In fact, as compared to the previous year, the export performance has improved.

The fundamental problem has been the sharp fall in the investment rate. Gross fixed capital formation rate stood at 34.3% in 2011-12. This started falling steadily and touched 29.3% in 2015-16. It fell further to 27.1% in 2016-17.

According to the latest numbers, in the first quarter of 2017-18, it stood at 27.5%. Since the public investment rate has not shown any decline (it stands at 7.5% of GDP), it is the decline in private investment, both corporate and households, that has been responsible for the steady fall. While the fall in corporate investment is steep compared to what was achieved in 2007-08, it has more or

less stabilised at a lower level of around 13%. Household investment, however, has continued to decline even in recent years. Household here includes not only pure households but also unincorporated enterprises.

Where the jobs are: on the unemployment rate

Deep concerns have been expressed about the fact that the growth that we have seen in recent years has not resulted in an increase in employment. The current period has therefore been described as one of ‘jobless growth’. It may be noted that data on employment are not very reliable. Firm data are available only for the organised sector. The rest are estimated through surveys. In fact, in the case of unorganised sectors, very often the position is one of ‘underemployment’ rather than unemployment. Growth can occur because of two reasons. One, it results from better utilisation of existing capacity. Two, it can come out of new investment. Whatever growth we have been seeing recently has come out of better utilisation of capacity rather than new investment. It is real growth spurred by new investment that generates more jobs.

Another intriguing factor about the falling investment rate is that the last few years have shown a steady and substantial increase in foreign direct investment (FDI). FDI inflows in 2016-17 were at an all-time peak of $60 billion. In the first quarter of 2017, the inflows were $10.9 billion. With this type of inflow and if the investment rate has not grown, the one surmise that one can make is that much of the FDI has gone into acquiring old assets rather than going to greenfield projects. All this implies is that domestic investors continue to remain shy.

What can be done to stimulate private investment? First, in creating an appropriate investment climate, reforms play an important role. Some of the noteworthy changes that have happened in the last few years are the passing of the bankruptcy code and GST legislation, and modifications in FDI rules.

We must continue with the reform agenda and there is still a lot to be done in the area of governance. Second, financing investment has taken a beating because of the poor health of banks. Banks in India today are universal banks providing both short-term and long-term credit. The sharp reduction in the flow of new credit has also put prospective investors in a difficult situation. To resolve the non-performing asset (NPA) problem, banks need to take a haircut. To bring banks back to good health, recapitalisation has become urgent. The government should go beyond the amount indicated in the Budget regarding disinvestment and fund banks through the money raised by disinvestment. Third, a close look must be taken at stalled projects to see what can be done to revive those which are viable. This is indeed a low-hanging fruit. In fact, this must be part of an overall effort to hold consultations in small groups with investors to understand and overcome the obstacles that come in the way of new investment.

Not all investor groups are plagued with intractable problems. Industry-by-industry consultations and analyses are needed to pinpoint problems and their solutions. Fourth, even though the progress of small and medium industries is very much dependent on the fortunes of the large, a separate look at medium and small enterprises may be needed to prod them into new investment.

To sum up, the growth rate in 2017-18 is unlikely to exceed 6.5%. Once the glitches and fears of the GST are over, the growth rate may pick up. Our goal must be to achieve and sustain a growth rate of 8% and above over an extended period. The Achilles heel is private investment, which has been steadily falling. However, there has been a slight pick-up in public investment recently. That is not enough. Only when the two engines of public and private investment function at full throttle will India fly high.

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