Sliding economic growth: What is to be done?

Policymakers and pundits alike have been unpleasantly surprised by the sharp decline in gross domestic product (GDP) growth in the first quarter of 2017-18 (Q1 2017-18) to only 5.7%. The surprise is unwarranted because quarterly growth has in fact been steadily declining from a peak of 7.9% recorded in the first quarter of 2016-17 (Q1 2016-17).

The growth decline was announced the day after the Reserve Bank of India (RBI) released data indicating that almost 99% of the demonetized notes had come back. Hence the critics and defenders of demonetization re-engaged with renewed vigour in debating its impact. To that has been added the adverse growth impact of de-stocking due to the implementation of the goods and services tax (GST). However, it would be a serious mistake to believe that the dip in growth is largely attributable to these temporary shocks. The slide in growth had started well before either of these shocks hit the economy.

Demonetization, whatever its actual purpose, was an administrative disaster. Had adequate preparations been made to build up supplies of new notes before demonetization and quickly re-monetize the economy, we would not have seen the cash rationing, the endless queues, the chaos and the hardship that followed. Unfortunately, the disruptive impact has also been concentrated in a few employment-intensive segments of the economy: the unorganized sector, real estate and construction, as I had anticipated in my 18 November 2016 column *(goo.gl/bi99c6)*.

We are virtually data-blind about the specific impact of demonetization on employment or output in the unorganized sector since GDP in the sector is estimated indirectly by benchmark blow-up methods linked to the corporate sector. We do know from the valuable 73rd round of the National Sample Survey that there were 63 million such un-incorporated non-agricultural enterprises in 2015-16 employing about 111 million workers, i.e. less than two workers per enterprise. Over 60% of these were single worker “own account enterprises”. These unorganized sector enterprises were more or less evenly divided among manufacturing, trading and other services. Productivity was extremely low in the sector at less than Rs2 lakh per worker and the total value addition of the sector was only Rs11.5 trillion.

While demonetization may have had a severe negative impact on employment and output in the sector as some have suggested, its negative impact on last year’s annual growth on that account would have been modest because of the low total value addition in the sector. By our reckoning, the overall negative growth impact of demonetization was less than 1% of GDP in 2016-17, and extending into the first one or two quarters of the current year, as I had noted in my 20 January column (goo.gl/xXKgwW).

GST related de-stocking has also had an adverse impact as is evident from the sharp decline in stocks growth to only 1.2% in 2017-18 (*see table*). However, this is a temporary disruption, triggered by uncertainty about how GST would be applied to goods already produced before the tax was rolled out. It will be eliminated once the administration of the new tax system settles down.

To recapitulate, the adverse impact of demonetization and GST on growth is relatively modest and temporary. As noted at the outset, the steady decline in quarterly growth started long before these shocks hit the economy. What then accounts for the slide in growth?

The answer will be evident from the adjoining table which shows how different components of aggregate demand in the economy have behaved in the last five quarters. Growth today is rather like the flight of a six-engine plane where one engine is going full throttle while the other five are

slowing or shutting down. The engine propping up growth is government final consumption expenditure. It grew by 17.2% in Q1 of 2017-18, which is higher compared to growth in Q1 2016-17. All the other positive components of demand have been slowing down while the negative components have grown dramatically.

The largest component is private final consumption expenditure, accounting for more than half of GDP. It grew by 6.7% in Q1 2017-18, which is not low but much lower than the 8.4% growth recorded in Q1 2016-17 (*see table*). In advanced countries, consumption is driven by income and wealth effects. In a low middle-income country like India, consumption demand is mainly dependent on income. Hence the slowdown in consumption growth is a reflection of sliding GDP growth rather than its autonomous determinant.

The two main autonomous drivers of demand growth, apart from government consumption expenditure, are fixed investment or gross fixed capital formation (GFCF), and the balance of trade. Of these, GFCF declined quite sharply to only 1.6% in Q1 2017-18, down from 7.4% in 2016-17Q1 (*see table*). The slippage appears even more sharply in the index of industrial production data, which shows that production of capital goods actually declined by 3.9% in Q1 2017-18. The decline in June was by as much as 6.8%. This decline reflects the sharp slowdown in private investment.

This particularly worrying trend has persisted since the investment rate peaked at over 34% in 2011-12. By 2016-17, it had come down to 29.3%. Private investment, which accounts for the bulk of investment, came down from 27% in 2016-17 to only 21.9% in 2016-17. The decline has continued in 2017-18. Despite the pump priming efforts of the government, attempts to reduce infrastructure bottlenecks and improve the ease of doing business, nothing seems to be working. Many Indian entrepreneurs are reported to be increasingly investing abroad rather than in the country.

Saying that investment is an autonomous driver of growth was an oversimplification. Private fixed investment depends very much on recent trends and prevailing business conditions. These include the logistics and power constraints, the difficulty of doing business and the failure to come to grips with non-performing loans (NPL), especially in public sector banks, which has shrunk the flow of credit. Only irrational exuberance can lead us to believe that the private investment cycle will revive without a significant turnaround in these conditions.

The other major autonomous source of demand is the external trade balance. In India’s case, this is a leakage of demand to the rest of the world, a negative component, since India runs a trade deficit. This negative trade balance has gone up by an alarming 295% in Q1 2017-18 compared to Q1 2016-17 (see table). This is a massive negative shock to the economy, arising from the slowdown in export growth while imports have grown by over 13% in real terms. The sharp rise in imports has occurred despite prices of commodities, especially oil, remaining subdued. On the export side, weak global demand is no doubt a part of the problem. But other competing countries have done better and raised their share of global exports while India’s share has declined.

This sharp deterioration of the trade balance is primarily attributable to appreciation of the exchange rate, which has made imports cheaper and exports more expensive in relative terms. Annual fluctuations apart, the 36-country trade weighted real effective exchange rate (REER) compiled by the RBI has seen a rising trend for several years. It is about 18% higher now compared to 2006-07. The appreciation has been particularly marked since January this year. Hence the sharp rise in the trade deficit.

Two remaining elements of aggregate demand require brief remarks. I have commented on the slowdown in stock growth, clearly an impact of GST related uncertainties. The other component is

valuables, which presumably includes gold, jewellery, paintings, antiques and other such exotic items. This component, which has grown by about 200% in Q1 2017-18 compared to Q1 2016-17, is a diversion of demand from current streams of production.

Given this depressing picture of demand, what is surprising is not that GDP growth has declined in 2017-18 Q1 but that it has not declined further. The key question is what can the government realistically do to turn around this dismal trend.

It is quite easy to set out a long menu of all that needs to be done. But two points need to be kept in mind. One is state capacity. As is evident to every citizen, there are limits to what the state, in particular the executive branch, can deliver. Overloading the government with too many goals, policies and programmes simply leads to a growing gap between the goals on paper and achievements on the ground.

The other point is that the government is now well into the fourth year of its term. The final year leading up to the 2019 election can be written off for policy or reform purposes since the government will be in election mode. Politically popular measures will get priority over all else. In other words, there is only a very narrow window, if that, to attend to any serious policy measures.

Given that context, it may be best for the Central government, and the RBI, to focus on just a couple of key measures that are implementable and could have a quick positive effect. The first is to control and turn around the appreciation of the exchange rate, something that the RBI could easily accomplish in cooperation with the government. The several available options to do this are well known. The second move would be to finally bite the bullet on the NPL problem of public sector banks. The bankruptcy code and other related developments have set the stage for this to be done. What is required is the will of the political leadership to get it done.

These two moves alone could bring about a sea change in the business environment and the outlook for economic growth. That in turn would provide the space to attend to other reform measures in a more calibrated manner over the medium to long term to place the country on a sustainable and employment-intensive high-growth path.

Sudipto Mundle is emeritus professor at the National Institute of Public Finance and Policy and was a member of the Fourteenth Finance Commission.

Comments are welcome at theirview@livemint.com

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