Source : www.thehindu.com Date : 2018-09-11

CAUSE FOR CAUTION: ON INDIA'S GDP GROWTH

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Demographic Economics & various Indexes

A question being raised about the GDP estimates for the first quarter of this year (April-June) is: How should 8.2% GDP growth be interpreted in, or reconciled with, the overall context of some of the pronounced trends in the economy? These include the depreciating rupee, rising bank bad loans, or non-performing assets (NPAs), a trade deficit that has shot up to a five-year high, and retail fuel prices that are inching up every day.

One of the explanations being offered for the missing feel-good sentiment is that the faster growth has come on a low base which has produced a statistical effect, making growth appear faster. This is partly correct. The low base does explain a part of the growth estimated, but not all of it.

The full picture emerges from sectoral estimates, which show that while some parts of the economy grew faster, a few others did not. Agricultural GDP growth quickened as two successive years of good rains improved farm produce. Manufacturing and construction, both industries that were dealt a severe shock by demonetisation, recovered, as the cash shortage moderated. Policy support — such as simplification of the messy Goods and Services Tax collection systems — can strengthen this revival. If nurtured, it can be employment-positive.

Services growth slowed. Industries such as trade, hotels and transport, and the financial, real estate and professional services fall in this segment, as do public administration and defence services. Services growth is relatively more representative of the economic sentiment of the vocal among urban and semi-urban Indians. The performance of services probably explains the sense of disconnect with the growth estimate being expressed in some quarters.

Despite slowing as compared to a year ago, the services sector grew faster than the agricultural GDP. It is too early to conclude if rural distress — to address which the Narendra Modi government announced budgetary support — has ended or reduced significantly. Rural wage growth has remained stagnant for the past four years.

Surprisingly, the slower services sector growth has not been a drag on consumption. Private consumption expenditure growth has quickened, relative to the preceding quarter, as well as compared to the same quarter last year. The strong, sustained growth, despite the high base, suggests that a consumption boom is in the making. Government salary and pension hikes including at the State level are feeding this consumption spree that is funded by taxpayer money and has remained unaffected by the sharp surge in retail fuel prices. Consumer industries are also reporting robust rural sales growth. Pockets of the rural economy — land-owning large farmers, for instance — appear flush with disposable income.

The cause for caution is that the GDP growth continues to be powered by consumption, not investments. Consumption-led growth is sustainable up to a point, especially if it is financed by expanding the government (Centre plus States’ cumulative fiscal) deficit. The high growth in the years preceding the global financial crisis was driven by savings and investments. After the global economic downturn disrupted that trend, an investments famine followed.

A big expectation was that with Mr. Modi in the driver’s seat, investments would revive, but, as the quarterly estimates remind us, the economy is still not out of the investments slowdown. The share of investments in GDP dropped from 32.2% in January-March to 31.6% in April-June this

year (although it is slightly better than the 31% in April-June 2017) — a direct consequence of the worsening NPA crisis.

A recapitalisation of banks was undertaken. It has not measured up to the problem. The insolvency mechanism has just about started functioning after dithering and delays. The government, in spite of its majority in Parliament, has made little progress in reforming public sector banks. Even the Nirav Modi scam could not shake it out of inaction.

With the government upbeat over the 8.2% growth, the risk is that in all the excitement, the message from the quarterly estimates (on the sustainable drivers of growth) might be lost.

The estimates for the subsequent quarters of this year will not enjoy the benefit of the low-base effect. First quarter estimates are early indicators and not necessarily representative of the remaining nine months of a year.

To sustain the 8%-plus growth rate beyond the first quarter, through the rest of the year, will require a far more pro-active policy push than appears probable in an election year that is also fraught with global economic challenges and mounting macroeconomic pressures. Ranging from rising international crude prices to the risk of inter-country trade wars, these are likely to keep the current account deficit — and therefore the rupee — under stress. A depreciating rupee will inflate retail fuel prices, unless the Central and State governments cut the taxes on them. But tax cuts will increase the fiscal deficit. The Reserve Bank of India can hike interest rates to arrest the rupee's depreciation. But that will further increase the cost of borrowing, including the government's debt.

Reforms, by removing bottlenecks, could have promoted growth even in an environment of rising macroeconomic vulnerability. But Mr. Modi's Independence Day speech has not spelt out any reform measures to be expected in the run-up to the general election. As of now, there are no signs that the full-year growth will beat the forecasts, most of which are about 7.4%.

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