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Why the economic slowdown, and how to fix it?

The ministry of finance is caught in a deficit fetishism that seeks to limit the fiscal deficit to 3.5% of GDP

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The slowdown in the economy is headline news. Growth in gross domestic product (GDP) has plummeted by 3.5 percentage points in just six quarters, from 9.2% in January-March 2016 to 5.7% in April-June 2017. The Reserve Bank of India (RBI) has slashed its GDP growth forecast for 2017-18 from 7.3% to 6.8%. So has the International Monetary Fund (IMF) to 6.7%. Former minister of finance Yashwant Sinha's article arguing that "the economy...on a downward spiral, is poised for a hard landing" put the cat among the pigeons. There is a slugfest in the media between supporters and critics of the government. But that is not all.

Captains of industry, usually silent or docile, are voicing their concerns about the economy, not only on ease of doing business but also on scarcity of jobs. Data for 107 companies in the organized sector, excluding information technology and financial services—part of the BSE 500—show that the number of persons employed by them has declined by more than 2% between end-March 2015 and end-March 2017. The latest RBI survey in six metropolitan cities shows eroding consumer confidence, dipping business sentiment in manufacturing, mounting concerns about jobs, and sliding growth perceptions.

The response of the government is two-fold. There is a denial mode that dubs critics as Cassandras or prophets of doom. There is a damage-limitation mode that seeks to mollify people with doses of populism, such as the cut in excise duties on petrol and diesel or goods and services tax (GST) reliefs and concessions to small businesses and exporters. This approach circumvents the issue. It is essential to recognize that there is a problem, so that there can be a meaningful debate on possible solutions.

To be fair, evidence on the recent slowdown in growth must be situated in its longer-term perspective. The period 2003/04-2007/08 witnessed the most rapid sustained GDP growth in India at 8.8% per annum, riding on the boom in the world economy. Then came the bust, as growth dropped to 3.9% in 2008-09. Surprisingly, GDP growth rose to 9.5% per annum during 2009/10-2010/11. This recovery was attributable to counter-cyclical macroeconomic policies, the size of the home market and a financial sector less fragile and more regulated than elsewhere. But the resilience did not last long. Growth slowed to 5.4% per annum during 2011/12-2013/14, as fiscal imbalances mounted, inflation quickened, and the current account deficit in the balance of payments widened.

In retrospect, it is clear that the present National Democratic Alliance (NDA) government inherited a difficult economic situation which was a legacy of the last three years of the United Progressive Alliance (UPA) government. It was good fortune, more than anything else, that resolved these problems. The sharp drop in world oil prices, from more than $110 per barrel to less than $50 per barrel, continued as a bonanza for three years. It slashed the current account deficit, brought inflation under control, and helped moderate fiscal deficits. GDP growth also revived to an average level of 7.5% per annum during 2014/15-2016/17. But the comfort derived from this revival was unwarranted. It concealed the structural constraints on growth that have persisted. And it meant a missed opportunity to return the economy to a sustainable path of more rapid growth. It would have been easier and wiser to act then. The problems have resurfaced now. These cannot be ignored.

There is a popular perception that the slowdown in economic growth, which has continued for six successive quarters, is attributable to the demonetization in November 2016 and the introduction of GST in July 2017, but this belief is not tenable since it can at best explain the decelerating growth in the last two quarters. Of course, there can be no doubt that demonetization has had an adverse impact on output and employment in the economy, particularly the informal, unorganized sector, which would have affected growth in 2016-17 and will do so in 2017-18 as well. Similarly, GST has probably had an adverse effect on output, in the April-June 2017 quarter, on account of production cuts and destocking before its introduction. Yet, it is clear that even if these episodes have temporarily accentuated problems, they are not responsible for the slowdown. The structural constraints on growth lie elsewhere and have been with us for six years rather than just six quarters.

The manifestations are apparent. There is a crisis in agriculture that runs deep. GDP per capita in the agricultural sector has been less than one-tenth GDP per capita in the non-agricultural sector for 25 years. Growth in output is monsoon-dependent. Employment creation is negligible. The outcome is rural distress. The share of manufacturing in GDP and employment is lower than it was 25 years ago. India's share in industrial production and manufactured exports in the world economy has declined steadily. The beginnings of de-industrialization are discernible. Thus, GDP growth is supported largely by the services sector, while employment growth in the economy has been sustained essentially by construction activities and the informal services sector both of which have been hurt by demonetization.

In terms of macroeconomics, the reasons underlying the slowdown in growth—investment and exports—have remained unchanged for the past six years. Investment (gross fixed capital formation) as a proportion of GDP dropped from 31.8% in 2011-12 to 28.3% in 2013-14 and from 30.4% in 2014-15 to 27.1% in 2016-17, so that the investment-GDP ratio dropped by 3.5 percentage points in the last three years of the UPA government and by 3.3 percentage points in the first three years of the NDA government. Merchandise exports as a proportion of GDP were in the range 16-17% during 2011/12-2013/14 but dropped from 15.2% in 2014-15 to 12.2% in 2016-17 (by 3 percentage points). The US dollar value of merchandise exports stagnated during the last three years of the UPA and declined in the first three years of the NDA.

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It is important to understand why investment and exports are important determinants of economic growth. First, the three sources of growth from the demand side are consumption, investment, exports. However, consumption, whether in the private sector or in the government sector, depends on their respective income levels. Thus, investment, which is decided upon within the economy, and exports, which depend on world demand for our goods, are the primary, autonomous, sources of demand that drive growth in output. Second, investment and exports are also critical determinants of growth from the supply side. Investment creates capacities or raises productivity, both of which increase output from the supply side. Exports, which must be price- and quality-competitive in world markets, raise efficiency and productivity of exporting firms to drive growth in output.

Investment levels are influenced by many factors such as investor confidence, bank lending, and infrastructural constraints, but interest rates are by far the most important factor for they determine the profitability of investment. Between 2013-14 and 2015-16, the RBI repo rate, which sets interest rates in the economy, was reduced by a mere 1.25% although inflation came down by 9 percentage points in terms of the wholesale price index and almost 5 percentage points in terms of the consumer price index, so that real interest rates rose by as much as 4-8% percentage points. Investment was stifled. The opportunity to stimulate investment by dropping interest rates sharply was missed out altogether. The RBI repo rate was reduced by a mere 0.25% in 2016-17, when inflation was 3.7% in wholesale prices and 1.7% in consumer prices. The lowering of the RBI repo rate by 0.5% in 2017-18 so far is too little too late.

The RBI is caught in a monetarist ideology, in the belief that inflation can be controlled by high interest rates

The exchange rate is a crucial price that determines the amount of rupees earned per dollar of exports and exercises an important influence on the profitability of exporting firms. Between January 2014 and June 2017, the rupee appreciated by 10% in nominal terms and 15% in real terms (adjusted for inflation). The poor export performance in this period is no surprise. In an earlier column, I have explained why and how a strong rupee hurts exports.

What should be done to address the slowdown in the economy? The answer is simple. It would be obvious to undergraduates in economics. It is also common sense. If there is a slowdown or downturn in an economy, governments should use counter-cyclical, expansionary, macroeconomic policies to revive growth. Fiscal policy should provide a stimulus, preferably by stepping up public investment. Monetary policy should provide a stimulus to private investment by lowering interest rates. The government is doing the opposite by adopting pro-cyclical policies.

The finance ministry is caught in a deficit fetishism that seeks to limit the fiscal deficit to 3.5% of GDP. But there is nothing in macroeconomics that stipulates an optimum level to which the fiscal deficit must be reduced as a proportion of GDP. Government borrowing is always sustainable if it is used to finance investment and if the rate of return on such investment is greater than the interest rate payable. The RBI is caught in a monetarist ideology, long after inflation-targeting has been discredited in most countries, in the belief that inflation can be controlled by high interest rates. Such thinking is based on a flawed belief system about the causes of, and remedies for, inflation. Inflation warriors in India fail to recognize that it was the low oil prices rather than the high interest rates that tamed inflation.

The way forward, then, is to allow the fiscal deficit to rise by 0.5% of GDP, using that to finance public investment, and to drop interest rates in steps by at least 2 percentage points, which would also help the exchange rate depreciate. Together, these would stimulate investment and promote exports, to revive economic growth. The recent slowdown is a warning signal, if not an alarm bell, for the Modi government, now more than two-thirds of the way through its tenure. The performance of the economy shapes the well being of people who in turn decide election outcomes.

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