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THE WIRE

ECONOMY

Is India's Economic Growth Slowdown Temporary or Technical?

BY SASHI SIVRAMKRISHNA ON 04/10/2017 • 1 COMMENT

Solutions involve either an immediate fiscal or monetary stabilisation policy, or pushing through further supply-side structural reforms.

What policy options do we have to counter the present downward trend in the Indian economy? Credit: Reuters

India's GDP growth has fallen (https://tradingeconomics.com/india/gdp-growth-annual) linearly over the last six quarters, from a high of 9.2% in Q3-2016 to 5.7% in Q4-2017 (https://thewire.in/172710/indias-gdp-growth-slows-5-7-june-quarter/). Going by the definition of the National Bureau of Economic Research, a US economics research organisation, and comparing India's macroeconomic data it would not be inappropriate to say that we are currently in a recession. The UK and the European Union however, consider an economy in recession only when real GDP growth actually turns negative over two consecutive quarters; by this criterion, with a positive growth rate of 5.7%, we are far off from being in a recession. Whatever definition of a recession one may abide by, the predicament that we now face requires the attention of policymakers. But what policy options do we have to counter the present downward trend in the Indian economy?

The answer to this question depends on how we view the cause of the problem. While some, especially those supporting the economic policies of government, see it as a temporary or "technical" issue (https://www.ndtv.com/india-news/gdp-growth-rate-slumped-to-5-7-due-to-technical-reasons-amit-shah-1748177) whose effects will soon wane, others view this as a more serious crisis created by a barrage of supply-side shocks to the economy; a stressed banking sector, demonetisation (https://thewire.in/173595/demonetisation-is-a-clear-case-of-how-public-policy-should-not-be-made/) and GST implementation (https://thewire.in/178844/modi-government-eyes-spending-cuts-as-glitches-in-gst-hit-revenue/) as well as disruptions in the agrarian sector (https://thewire.in/180312/demonetisation-marathwada-farmer-incomes/) that have all contributed in strong measure to the ongoing economic slide. With reference to the latter, I identify two standpoints; first, that while the longer-term story of structural reforms remains intact, there is a need for immediate stabilisation policy – fiscal and/or monetary policy – so that the short-term shock does not pull the economy into a deflationary spiral and second, that these shocks have impacted agriculture and industry so severely, especially the informal sector, that the crisis is now a deep structural issue rather than merely a short-run one. In this case, India's growth story has been derailed and the pain must be endured by the masses for a long while to come. The blame for ending up in this mess rests on the government because of its poor understanding of economic realities and adventurism in policymaking and implementation.

When the crisis is viewed as essentially a technical one the suggested policy response is categorical; the government should implement further supply-side structural reforms. What others consider as supply-side shocks are actually bold structural reforms – including schemes like Jan Dhan Yojana (https://thewire.in/65653/jan-dhan-yojana/), PAN-Aadhaar linkage (https://thewire.in/145800/sc-upholds-law-link-aadhaar-pan-grants-partial-stay/), digital payments (https://thewire.in/177642/narendra-modi-digital-india-aadhaar-bhim-app/), mobile banking, etc. – that will sooner than later yield positive results (https://commercial.jpmorganchase.com/pages/commercial-banking/executive-connect/india-economic-transformation). Put differently, the slide that we observe today is indeed a short-run aberration before India moves on to a high trajectory (8%) growth path, perhaps as soon as the next fiscal (https://blogs.timesofindia.indiatimes.com/Swaminomics/dear-fm-yashwant-sinha-is-wrong-so-dont-be-tempted-by-a-fiscal-quick-fix/). Rather than a fiscal quick-fix the government must undertake even more structural reforms for the longer-term benefits are bound to be larger than the short-run costs.

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As an academic economist, it is clear that this line of thinking emanates from what we call the classical school which draws from Say's Law (https://www.economist.com/news/economics-brief/21726050-third-brief-our-series-looks-reasoning-made-jean-baptiste-say) – supply creates its own demand – and one which has in recent times converged into the much dreaded idea of "austerity". Moreover, although there is no explicit mention of it, I see an undercurrent of a larger vision of these supply-side shocks (especially GST); although this may cause widespread closure of several micro and small industries in the informal sector – especially of the low technology, "proto-industrial" type – there is a subtle hope that the rapid expansion of the formal (private) sector will be able to absorb the displaced persons in the not-so-long term. A qualitative change in industrial structure – from informal to formal – is required for India to not merely to achieve high and sustainable growth in the longer-term but more importantly, to emerge as a truly advanced nation on the

world stage. While the narrative seems enchanting, the issue – even in the longer-term – is whether economic growth in modern/formal industry will be able to employ India's teeming masses who suffer from the handicaps of poverty and deprivation.

An employee works inside an undergarment factory in Kolkata, India, February 1, 2017. Credit: Reuters/Rupak De Chowdhuri/File Photo

The second viewpoint that I see emerging in the present debate is one which argues that while the supply-side reforms are indeed an aberration (a technical issue), they could be disruptive enough to drag the economy into a vicious downward spiral that lasts beyond just a few quarters and turn the problem into a structural one. It is therefore *politically* exigent – given the forthcoming general elections – that the government acts to restore growth at least to its earlier levels of 7% to 7.5% as soon as possible. This stream of thought therefore considers the need for adoption of active stabilisation policies – fiscal and monetary – to tackle the short-term crisis even as the longer-term narrative of structural reforms remains on course. However, as I argued in an earlier article (https://thewire.in/181428/fiscal-stimulus-package-indian-economy/), the danger of such a Keynesian fiscal expansion in the present context of supply-side shocks is that the economy could be dragged into stagflation – stagnating growth with accelerating inflation. The reason for this possibility is that increases in demand arising from larger

government spending may not be able to induce an expansion of production and sale of goods and services because of the disruption on the supply-side of the economy and in spite of the existence of low capacity utilisation rates across various sectors of the economy. This may therefore lead to rising inflation without sufficient real growth in output.

What about monetary policy or a cut in interest rates by the Reserve Bank of India (RBI) to bolster private sector investment spending and prop up the growth rate? It would not be out of place to point out that many commentators (including Subramanian Swamy (http://indianexpress.com/article/india/india-news-india/raghuram-rajan-planted-time-bomb-in-the-indian-financial-system-that-will-explode-in-december-swamy-2844656/)) have asserted that it was the former RBI Governor, Raghuram Rajan's tough stance (https://thewire.in/42392/raghuram-rajan-has-got-it-wrong-on-inflation-and-interest-rates/) on interest rate hikes that derailed (http://www.sunday-guardian.com/analysis/raghuram-rajans-tandava-spells-death-for-economy) private sector investment and is perhaps the true trigger of the present Indian economic slowdown. What is now needed from the RBI is a reversal of the damage and an immediate cut (or even a slash) in interest rates, especially given low inflation rates over the last several months. But will it work now in stimulating growth?

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Keeping aside the decision of the monetary policy committee on the repo rate that will be taken on October 4, it is necessary to raise some general doubts on the efficacy of monetary policy at this juncture. Monetary policy transmission through cuts in interest rates would have been likely if the was a systemic strong demand for liquidity (reserve money from the RBI) in which case the money market rate would have been close to the repo rate. Instead, the situation in India for the past several months, since demonetisation actually, is that the banking system is flush with liquidity and the RBI has making attempts to drain

this surplus liquidity to prevent rates from falling. In fact, the short-run money market rates even breached (http://www.thehindubusinessline.com/opinion/mpc-must-attend-to-liquidity-surplus/article9867704.ece) the lower bound of reverse repo rates as the RBI did not have adequate government securities to conduct reverse repo operations. Moreover, in addition to the poor demand for credit, banks too are simply not willing to lend. This arises from a fear to take risks (accountability issues if debts turn bad) as well as their stressed balance sheets of both, the corporate sector and the banks. There is yet another issue that needs closer examination before depending on monetary policy to bolster growth; the level of confidence in the economy. Investment decisions are almost always based on expected sales and unless businesses see general economic conditions improving, the demand for credit will remain low whatever may be the rate of interest. In an article (https://www.forbes.com/sites/realspin/2016/10/04/low-interest-rates-are-hurting-growth/#6a619ba3b605) published in the *Financial Times*, an American economist questions a common assumption regarding monetary policy transmission.

> The theoretical and econometric models used by the Fed greatly overstate the impact of interest rates on investment spending. Thirty-two years in the private sector have taught me that their [interest rate] impact on investment in plant and equipment by large publicly traded companies is negligible. Ask a business leader if he or she has ever made an investment decision – yeah or nay – that would have been reversed by a two percentage-point move in interest rates, and you'll get a one-word answer: "Never."

It would also be interesting to study the importance of interest rate costs to firms in India; for instance, *just as an example*, I found (http://www.moneycontrol.com/stocks/marketinfo/interest/bse/auto-cars-jeeps.html) that interest costs as a percentage of net sales were just 0.13% for Maruti Suzuki and 0.33% for M&M. Obviously, a cut in interest rates by a few basis points will not fundamentally alter the profitability of these companies.

Finally, the popular discourse often ignores another possible repercussion of interest rate cuts; its impact on consumption expenditure. While low interest rates may reduce the costs of borrowing it also affects household incomes especially those who live off returns from fixed-income securities like fixed deposits and bonds. The net effect of these conflicting impacts of interest rate cuts makes monetary policy a rather tentative instrument in reviving growth in a recessionary economy. It may, therefore, be expedient for the RBI to focus on containing inflation rather than failing on both targets.

Also read: As the Economy Slumps, How Many Jobs Is It Really Taking With It?

If the two major policy options, namely fiscal and monetary, are inappropriate and inadequate respectively to revive economic growth at this point of time then the only option for the government would be to hope that the crisis is indeed of a technical nature that will resolve itself and the economy gets back on track – soon. But what if it doesn't and the supply-side shocks have indeed caused severe damage to the production structure, particularly in the informal sector? And what if the economy slows down rapidly in the course of the next fiscal, not just in the informal sector but also in the formal corporate sector (http://www.business-standard.com/article/companies/don-t-expect-economic-revival-for-2-years-l-t-chief-a-m-naik-117092700064_1.html) emanating primarily from the lack of demand and the twin balance sheet crisis? What is the alternative policy framework available to the government? Is time then the only solution? This is also a fundamental question that political parties must pose and articulate an answer for; after all, to critique the government's policies is only half the story. And here too, are we really apprehensive about the vision and stratagem of the present government or is it the implementation which is being questioned (https://thewire.in/183573/modi-government-isnt-economic-growth-approach-flawed/)?

The biggest macroeconomic challenge for India is and will continue to be providing employment to millions of people while at the same time, raising standards of living. Jobless growth, low real wages and the divergence (http://www.livemint.com/Opinion/Vxmd5HHO8qeLuqYUiobbpM/Higher-productivity-equals-higher-wages-Not-for-the-Indian.html) between productivity growth and real wages makes us doubt the neoliberal narrative of economic (GDP) growth as a necessary and sufficient solution. Modern industry, particularly manufacturing is unlikely to create jobs in the numbers we need. As pointed out by Adair Turner (https://www.project-syndicate.org/commentary/developing-countries-demographic-denial-by-adair-turner-2017-09) the emerging scenario looks foreboding for countries like India.

> Adidas's "Speedfactory" in Ansbach Germany will soon produce 500,000 shoes per year with only 160 workers. A recent International Labour Organization report (http://www.ilo.org/public/english/dialogue/actemp/downloads/publications/2016/asean_in_transf_2016_r2_future.pdf) estimates that 60-90% of existing low-paid jobs in textiles and clothing in several Asian countries might be automated away.

With about 90% of the work force employed in the informal sector and the working poverty rate (http://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---sro-new_delhi/documents/publication/wcms_496510.pdf) at 35% (less than $3.10 per day), expecting formal sector jobs for the masses seems nothing less than a farfetched dream. The road to full employment with high standards of living will be a long and winding one.

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