

YES, NO, IT'S COMPLICATED

# Is the Indian economy on an upswing now?

YES



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Many policy initiatives have shown a clear productivity enhancing supply-side thrust

The Indian economy has shown a strong V-shaped recovery driven largely by domestic growth impulses. If one considers nine consecutive quarters since the fourth quarter of 2015-16, Gross Domestic Product (GDP) growth fell quarter after quarter from a peak of 9% to a trough of 5.6% in the first quarter of 2017-18. As is widely recognised, this was due to demonetisation and the transitory adverse effects of the goods and services tax implementation. These eventually subsided and for the last three quarters, growth steadily recovered to 6.3%, 7.0% and 7.7% in the second, third

and fourth quarters of 2017-18, respectively. This sharp recovery is based entirely on domestic factors as the contribution of net export growth to GDP has been zero or negative since the third quarter of 2016-17. From the demand side, two segments which have supported growth, particularly in the fourth quarter of 2017-18, are government consumption and overall investment demand. The growth in gross fixed capital formation was as high as 14.4% in the fourth quarter of 2017-18.

The real investment rate has also increased to 34.6% in the fourth

quarter of 2017-18, although paradoxically, the nominal investment rate during this period remained below 31%. This difference is explained by relatively lower implicit price deflator of investment goods when compared to that for consumption goods.

## Productivity focus

Many of the government's policy initiatives have shown a clear productivity-enhancing supply-side thrust including demonetisation and the GST. The new Monetary Policy Framework agreement has institutionalised a consumer price index (CPI) inflation target of 4% on average. Key policy initiatives (Make in India, Start-up India) also



aim at improving productivity. Two early policy successes are related to market determination of mineral and spectrum prices. The power sector further benefitted from

the Ujwal DISCOM Assurance Yojana scheme. For real estate and banking, the regulatory framework was changed. Additional fiscal space was created by better targeting of subsidies while expansion for rail/road projects was prioritised.

Two factors may create short-term drags on India's prospects for maintaining a sustained level of high growth: rising global crude prices and prospects of fiscal slippage. Global crude prices recently

touched \$80 a barrel for the first time since 2014. The supply factors include U.S. sanctions on Iran and the crisis in Venezuela.

On the demand side, according to the World Bank, world oil consumption grew strongly in 2017, up by 1.6% year-on-year. In 2018, U.S. consumption growth is expected to gather further momentum. Rising crude prices may adversely affect most indicators of India's macro balance including trade and current account deficits, inflation, exchange rate and fiscal deficit. Reversing a falling trend since December 2017, CPI-based inflation increased to 4.6% in April 2018 due to rising prices of petrol and diesel used for transport. Continued pressure on inflation may prompt the

RBI to revise the repo rate upwards during the current year.

The Centre's fiscal deficit-GDP ratio, after showing a steady improvement since 2014-15, slipped back to a level of more than 3.5% of GDP in 2017-18, exceeding the fiscal responsibility and budget management (FRBM) target of 3% and the budgeted target of 3.2%. With the general election around the corner, this situation may not improve in spite of the fact that the FRBM Act has been modified, shifting the policy anchor to achieving a debt-GDP ratio of 40% while retaining the fiscal deficit target at 3% of GDP. This target is now to be reached by March 2021.

The views expressed are personal

NO



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While growth estimates may point to an upswing, the euphoria may be premature

GDP growth estimates released by the Central Statistics Office (CSO) suggest that the economy grew at 6.7% in 2017-18 at 2011-12 prices. This, incidentally, is the lowest growth rate during this government's four years in power. GDP growth rate has decelerated sharply from the high of 8.2% in 2015-16, the first full year since the government assumed office.

But these estimates have also been celebrated as signs of a revival of the economy based on quarterly data – it showed GDP growth accel-

erate from a low of 5.6% in the first quarter of 2017-18 to 7.7% in the fourth quarter. While it may signal that the economy may be on an upswing from the depth it had reached, such euphoria may be premature.

The revival appears to be led by recovery in growth rates of public administration, defence, construction and agriculture. While there appears to be a genuine recovery in construction which has been lagging behind for some time now, the growth in public administration

and defence at 13.3% in the fourth quarter is almost double the growth rate in the third quarter.

The pattern is similar to 2016-17 and may reflect the changing pattern of government expenditure. The overall growth rate also appears to be better because of a better than expected performance in the agriculture sector.

## Rural distress

However, agricultural growth in real terms at 4.5% appears more of a statistical artefact than a story of turnaround in agriculture. Growth in nominal GDP in agriculture at



4.91% also happens to be the lowest growth in the fourth quarter since 2012-13. It is lower than the nominal growth of agricultural GDP in the fourth quarter achieved during the two drought years (2014 and 2015). By implication, the GDP deflator in agriculture at 0.42% also confirms a collapse in agricultural prices.

But herein lies the problem of the Indian economy. It is going through a period when domestic demand especially in the rural areas has almost collapsed. The demand deflation is not just evident from the implicit GDP deflators but

has also been confirmed from data on rural wages which continued to be in negative territory in real terms until January 2018.

Not surprisingly, there has growing farmer unrest in the rural areas against falling commodity prices. The strike in many agriculturally important States is a clear reflection of the level of distress. But it also is clear evidence of the fragility of economic growth.

But even in real terms, excluding agriculture and public administration (both of which remain vulnerable to different shocks and pressures), the overall growth rate of the economy actually shows a decline in the fourth quarter to 7.2%

compared to 7.4% in the third quarter.

While rural demand remains subdued, export demand has also plummeted with the export-GDP ratio reaching its lowest in a decade. With private investment and consumer demand sluggish, the only thing that is working for the economy is lower inflation. But with inflation rising once again, even this cushion is unlikely to be available in the future. Latest estimates may suggest that the worst may be over for the economy as far as the two shocks of demonetisation and the GST are concerned, but it is certainly too early to celebrate the revival of economic growth.

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A V-shaped recovery depends on export growth and also on private investment picking up

The 7.2% growth in the Indian economy during the October-December quarter has put the country in the highest growth bracket globally. Recovery will continue to be sharp going ahead, according to the Economic Affairs Secretary at the World Bank-IMF spring meetings in Washington DC. He added: "We have said this earlier that the first quarter (of FY18) was where we bottomed out, and we would see a very strong V-shaped recovery."

It is fairly well known that the quarterly estimates by the CSO for GDP growth are always based on projections, so they are not regarded as reliable. Equally important, in a highly informalised economy, where the share of the unregistered

economy is not very well known, all estimates of GDP growth, especially projections, are likely to be an issue.

We should also remind ourselves that even after a financial year is over, and the CSO announces a GDP estimate for the year ended, it is almost always further revised down the road. The firm assertions by Ministry of Finance have to be read in this context.

Expressions of optimism aside, is a V-shaped recovery possible if the investment-GDP ratio is still lowest in 10 years? It was 38% of GDP at its peak in 2017-18, fell to 31% in 2013-14, and further slowed over the last four years to under 29%. Moreover, capacity utilisation in industry has

been around 70% only.

## Over-optimistic

The RBI Governor had said two months ago that he expects the investment-GDP ratio to improve and added: "I think there are the first discernible signs of that when existing capacity utilisation reaches a certain level." He added that the reason he says that there are incipient signs is that the credit offtake (after a long time) is now in double digits, albeit in low double digits.

Given the tentativeness of his statements, to say that a V-shaped recovery is in the offing is a tad over-optimistic. The external environment is not exactly buoyant. Global growth had been slow till 2017, when it improved in the U.S., Europe, China and Japan. But the



most recent downside, which will have widespread consequences in India, is that oil prices, after being low for at least four years, have begun rising again. Second, the international trade environment, favourable until recently, has worsened with threats of a U.S.-China trade war. Third, interest rates have begun to rise in the U.S., and will continue to rise, reducing the prospect of more fund flow to emerging economies, including India.

Exports value fell sharply to levels well below the value of \$315 billion in 2013-14, were \$275 billion in 2016-17, and have only recently risen to \$303 billion in 2017-18. They were well below this level in the last several years. From their peak at 16% of GDP for merchandise ex-

ports just before the global economic crisis broke, they are down to 11.7% of GDP IN 2017-18 (the lowest ever since 2003-4).

A V-shaped recovery is contingent not only upon export growth but also private investment picking up. But the twin balance sheet problem is nowhere close to resolution. Under the circumstances, public investment is critical. The latter has mainly been driven by State governments. Fiscal consolidation by the Union government has been offset by the worsening of State balance sheets, partly on account of rising farm loan waivers. Thus the combined fiscal deficit of nearly 7% at present makes it less likely that State governments can offset the tepid private investment by increasing their public investment.

The main good news in recent times on revenue has been the 53%

rise in the number of tax payers under the GST, and increased formalisation of the economy bringing more entities in the tax net.

However, the Union and State governments face mounting fiscal pressures on account of rising international crude oil prices. The subsidy burden on governments has risen and as the fiscal deficit remains a source of concern, the governments remain loath to cut petrol and diesel prices.

The implication is that the inflation rate, which has remained low in recent years, is likely to rise. In any case, given that the path of fiscal consolidation cannot be abandoned for fear, inter alia, of losing credibility with international rating agencies, the potential for India spending its way out into a high growth path quickly remains limited.