Economy Plunging Headlong into Recession

Prabhat Patnaik

Volume II of the Economic Survey which was brought out by the Ministry of Finance a few days ago paints an extremely grim picture of the Indian economy. The growth rate of real Gross Value Added (GVA which is the appropriate thing to look at, since the GDP measure includes net indirect taxes and hence does not truly reflect output trends), was 6.6 percent for 2016-17 as a whole, compared to 7.9 percent for 2015-16. More importantly, the quarterly growth rate (i.e. the growth rate of GVA in a particular quarter over the corresponding quarter of the preceding year) kept declining in every successive quarter during 2016-17, the fourth quarter growth rate being just 5.6 percent, which was roughly 3 percent below that of the fourth quarter of 2015-16.

Besides, even this growth rate was artificially boosted by two factors: one was the unusually good agricultural performance because of favourable weather (real GVA growth rate in agriculture was 4.9 percent in 2016-17 compared to a mere 0.7 percent in 2015-16), and the other was the growth in Public Administration and Defence because of the 7th Pay Commission award. (This sector's real GVA growth rate for 2016-17 was 11.3 percent compared to 6.9 percent for 2015-16). If we take out these two sectors then we get what the Survey calls "Core GVA". The growth rate of "Core GVA" was just 6.2 percent in 2016-17 compared to 9.8 percent in 2015-16, a drop of 3.6 percent. And given the fact that the growth rate during the year was not just lower but declining through time, the fourth quarter growth rate in Core GVA was as much as 6.8 percent lower in 2016-17 compared to 2015-16. This is deceleration with a vengeance.

What is more, this deceleration is certain to continue into the next year. There are at least three strong reasons for this. One is that the effect of the increase in Public Administration and Defence will no longer be there, which in turn will affect the economy in two ways. The obvious way is the slowing down in this sector's own growth rate. But the less obvious one is the following.

If the government increases salaries by say Rs.100, then this directly gets counted as an increase in output of that magnitude (which is methodologically bizarre but let us ignore that for the time being). In addition however this Rs.100 gets spent, which increases demand and hence output in some other sectors. And when that happens then additional incomes are generated in those sectors which in turn also get spent and thereby generate still further incomes, and so on. This is referred to as the "multiplier" effect of the increase in government expenditure. Such a "multiplier effect" ensures that the overall increase in GVA as a result of the increase in government expenditure of say Rs.100 is a multiple of this sum, something like Rs. 300 or thereabouts.

When the Survey talks of the increase in GVA because of increased government spending owing to the 7th Pay Commission award, it refers only to the direct effect of this increase (in boosting this particular sector's GVA), not the total effect via the operation of the "multiplier". The 2016-17 GVA growth rate even in the "core" sector in other words was buttressed by the expenditure which occurred in the "non-core" sector of Public Administration and Defence and which got expressed in this sector's own GVA. If despite this fact the Core GVA growth in 2016-17 was just 6.2 percent, then what it would have been in the absence of this boost can well be imagined. By the same token however, next year not only will this boost not be there, but its "multiplier effects" too will not be there. Hence the slowing down in the overall GVA growth will be quite substantial for this reason.

The second factor working in the direction of further deceleration in the growth-rate next year is the stressed balance sheets of several companies belonging to the power and the telecommunications sectors. Such stressed balance sheets in turn threaten the banking system, especially the public sector banks which have given them huge loans, with a crippling burden of Non-Performing Assets. The question needs to be asked: why are the nation's public sector banks threatened, and not the private sector banks including foreign banks? The answer simply is that in the name of developing "infrastructure" the government coerced public sector banks into giving out large loans to private companies owned by the big corporates in these sectors. The private sector banks including foreign banks were smart enough to avoid falling into such traps and the government could not coerce them into doing so. As a result now it is the public sector banks that are facing a crisis and not the private sector ones.

Faced with such a crisis they are now reluctant to give out fresh loans. Of course the demand for loans has also come down because of the recessionary situation (which has even meant that real Gross Fixed Capital Formation in the fourth quarter of 2016-17 was lower in absolute terms than in the fourth quarter of 2015-16); but the Survey notes that the disbursement of credit has been even lower than the demand for credit. This situation is not going to change; on the contrary it will become even more crippling in 2017-18, which would be a further constraint on growth.

It is ironic that the stress of public sector banks is being used by the government to argue a case for privatizing them! Having coerced them into giving loans to private firms which were reckless in their investment decisions, and thereby pushed the banks into a crisis, the same government is now thinking of privatizing the same banks on the plea that the private sector is more careful and wiser in its decisions!

The third factor has to do with the external sector. It is clear that the U.S. is in no hurry at present to raise its interest rates, in which case countries like India where higher interest rates prevail will continue to get flooded with foreign financial investment which will lead to an appreciation of their exchange rates; at the very least India's exchange rate which has been appreciating of late is unlikely to decline in the near future. And this so when China has further depreciated its currency recently. India's exports therefore are likely to remain sluggish and witness a decline in their already meagre growth rate. This tendency will also get aggravated by Trump's effort to prevent the outsourcing of activities away from the U.S. which would hurt India's service sector exports.

When we add to all these factors the inevitable decline in real growth of the GVA in agriculture, which must occur because of the higher base in 2016-17 if for no other reason, then it is clear that the growth rate of the Indian economy is set to slow down further to a significant extent in 2017-18. The economy in short is plunging headlong into a recession. We have already been witnessing a sharp decline in job creation in the organized sector (for which we have data) in the last couple of years. This decline is going to be greatly aggravated.

Faced with this looming crisis, all that the Survey can suggest is a cut in interest rate. A cut in RBI lending rates may reduce the stress on the banks somewhat, because they will now have access to cheaper funds, but it is unlikely to make much difference to the impending recession. Investment which is lower in absolute terms in Q4 of 2016-17 compared to 2015-16, will not revive simply because borrowing has got cheaper; exports will not get boosted in a crisis-afflicted world economy merely with a .25 or a .50 percent rate cut; government expenditure is tied to fiscal deficit targets where interest cuts will have little impact; and consumption is governed by income itself, i.e. depends on the level of activity itself instead being an independent factor boosting such activity. True, one element of consumption, namely that which is stimulated by agricultural growth, could increase independently if agricultural growth increased. But we have seen above that the contrary will be true; and as for farm prices which have crashed for many crops, no significant improvement is on the horizon (in fact the Survey foresees a significant decline in inflation arising inter alia from subdued crop prices). It follows therefore that the government has no idea on how to combat this headlong plunge into recession.

In fact the Survey's commitment to "fiscal rectitude", come what may, is revealed in a little exercise it does to show that farm loan waiver will be demand-compressing in the economy (which it cites as an additional contributor to recession). This exercise shows that if Rs.100, say, of farmers' debt is taken over by the government (which is what loan waiver means), then the increase in farmers' demand because of such a move is Rs.25, while the government, because it is committed to maintaining the FRBM targets, will have to reduce its expenditure elsewhere almost to an equivalent degree, i.e. Rs.100, so that the net effect on aggregate demand is contractionary.

It does not occur to the Survey to suggest that if this be the case then there is absolutely no reason why in a demand-constrained economy, which the Survey admits India to be, the FRBM targets should not be violated. Why should the government remain a prisoner of some absurd piece of legislation which it had itself enacted, when the economy is plunging into a crisis and when enlarging government spending in violation of that legislation can possibly do no harm? True, international finance capital may get upset if the FRBM target is violated. But is this country going to be run for the benefits of its own people or of international finance capital? And if the latter threatens pulling out, which it will not necessarily do, then in such an extreme case some controls on capital flows could be introduced, which even the IMF now admits are not always "undesirable". All this however is beyond the gumption of the NDA government.