Downturn Blues*

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September did not begin well for the Narendra Modi government. As it prepared for a makeover in the form of a cabinet reshuffle with elections 2019 in sight, news came that India's GDP growth had slowed significantly to 5.7 per cent during the quarter April-June. This deceleration comes in the wake of a fall in growth rates from close to 8 per cent a year earlier to 6.1 per cent during January to March this year.

As is to be expected the government has chosen to attribute this trend to short term shocks, which will not dislodge the economy from a 7-8 per cent growth trajectory that is considered to be the magical norm under the NDA. T.C.A. Anant, the Chief Statistician of India, whose real job is to oversee the preparation of the figures and not explain them, declared at his press conference that the most recent April to June deceleration was not the consequence of the botched demonetisation, but of pre-GST apprehensions that had result in de-stocking. Wanting to clear their stocks before the new rules and rates apply, manufacturers had chosen to dispose of their stocks and not add to them with new production, was his claim. Since, when reporting the January to March 2017 deceleration to 6.1 per cent, he had similarly declared that the trend cannot be attributed to demonetisation, the Chief Statistician was at least being consistent. But the fact remains that a continuous deceleration in growth from 7.9 in the first quarter of financial year 2016-17 to a three-year low of 5.7 per cent in the first quarter of this financial year cannot be dismissed as being the result of unwarranted short term fears of some economic agents. What the figures do point to is a loss of dynamism in the principal commodity producing sectors in the economy—agriculture and manufacturing.

The most recent deceleration is disturbing also because it has occurred at a time when the government has chosen to loosen its purse strings and sustain, if not increase, spending. According to figures from the Controller General of Accounts, central government spending during the first four months of financial year 2017-18 (April to July) amounted to 38 per cent of the budgeted total, as compared with 33 per cent in the corresponding period of the previous year. This frontloading of budgeted expenditure should have had a stimulating effect on the economy in the short run. Yet growth has slowed.

Moreover, export performance has also improved considerably. India's exports, measured in dollar terms, rose by 8.7 per cent during April to July 2017, as compared with a fall of 3.6 per cent in the corresponding period of 2016. Though exports are by no means an important stimulus for growth in the Indian economy, this improved performance suggests that a poor global environment cannot be held responsible for the deceleration of growth in India.

That leaves the residual factor, which is private consumption and investment demand, the dampening of which must have been significant enough to overwhelm the stimulating effect that frontloaded government spending would have had. This contraction in private expenditure and demand has both long term and short term sources. The long term factor holding down private investment is the deflationary environment in which the economy has been placed by the fiscal component of neoliberal reform. Ever since such reform has been pursued, beginning in the early 1990s, a declared goal of the government has been to rein in the fiscal deficit. Since such fiscal consolidation is favoured by foreign financial investors looking for evidence of "macroeconomic stability", liberalisation of rules governing capital inflows and outflows make fiscal deficit reduction imperative. So, in the late 1990s the government chose to postpone adherence to strict fiscal deficit targets, the growing accumulation of the stock of portfolio investment in the country forced it to adopt the Fiscal Responsibility and Budget Management Act in 2003. The FRBM Act effectively tied the hands of the government and has since its passage resulted in a decline in the fiscal deficit to GDP ratio to 3.5 per cent in 2016-17.Since this occurred in a period when the government sought to move to an investor friendly tax regime, that capped and even reduced the tax-to-GDP ratio, a consequence has been curbs on spending that had an overall deflationary impact on the economy.

This, however, did not show through during the 2003-2008 high growth years, essentially because of a spike in bank lending facilitated by the liquidity injected by large foreign capital inflows. Consumption and investment spending financed by this credit boom also served as a stimulus for growth. Besides a sharp increase in retail lending, especially for housing, commercial bank exposure to the large corporate sector increased hugely. Much of this lending financed investments in the infrastructural area, that are characterised by long gestation lags and low returns. Since the government chose to privilege such investments by the private sector, huge loans for highly leveraged capital intensive projects were advanced based on the government's hype. By the start of the second decade of this century it was becoming clear that many of these projects were failing to generate cash flows to meet the interest and amortisation payments on the loans taken. What followed was a huge increase in non-performing assets which is proving to be an intractable problem for both the public sector banks and the government.

Having had to sacrifice profits or incur losses on account of provisioning for these bad loans, the banks have turned cautious, leading to a sharp slowdown in credit growth in recent months. The effect of this on demand and growth has been so adverse that even when the government sustains spending, demand is depressed and growth falters. Read in this fashion the deceleration in growth in recent quarters is by no means the result of self-correcting short term disturbances or shocks. Rather, the downward trend is the result of the inability of the system to sustain the artificial stimuli that the neoliberal policy environment had facilitated. Growth that was riding on a credit bubble has proved unsustainable, and the economy is in deceleration mode.

This, in fact,may be the beginning of the bust, unless the government can find alternative ways of propping up growth without violating its self-imposed fiscal consolidation measures. Recent actions signal three such possibilities. The first, is to accelerate privatisation and strategic sales so as to substantially increase the volume of non-debt creating capital receipts, that are excluded from the calculated fiscal deficit. Privatisation receipts have been set at a high of Rs. 72,500 crore in Budget 2017-18. They could be raised further. The problem is selling assets to finance current expenditures does not make financial sense. But a desperate government is hardly interested in fiscal correctness.

The second, is to transfer the so-called “profits” of the Reserve Bank of India in the form of dividend payments to the government which “owns” the central bank. There are no commercial operations which the central bank undertakes, so its profits are largely the result of income accruing from bank note issue (seignorage, or the profit accruing from the difference between the face value of money and the cost of physically producing it) and interest income from the holding of bonds and bills, both domestic and foreign, resulting from its asset and liquidity management measures. The budget had provided for a Rs. 58,000 crore transfer of such ‘paper profit’ from the central bank to the government. But, hit by demonetisation, the RBI has thus far delivered with only Rs. 30,659 crore out of its Rs. 44,000 crore surplus for 2016-17. The comparable transfer figure for 2016-17 was Rs. 65,876 crore. According to reports the government is pushing for more—perhaps the whole of the remaining Rs.13,000-odd crores.

Finally, there is a real danger that having pushed through the Goods and Services Tax and putting many commodities in the higher slabs, the centre would turn to indirect taxes on goods and services to garner the revenues needed for enhanced spending. Since the rules regarding sharing of these taxes between the centre and states have been laid out, the aim would be to set GST rates high enough so that the states would not have to be compensated for revenue losses, while the centre will see a substantial increase in revenues that can be attributed to better compliance. This seems to be a bet the government has placed. Whether it will win that bet or not is yet unclear. But that victory can only be partial. High rates that resolve the revenue problem can lead to destabilising inflationary trends. On the other hand, if revenues cannot be hiked and fiscal deficit targets have to be met to please international finance, expenditure must remain lower than needed to reverse the deceleration in growth.

As the NDA prepares to win itself a second term with a similar majority in 2019, this is a problem it will have to contend with. It is a problem that does not lend itself to easy resolution.

*** This article was originally published in the Frontline Print edition : September 29, 2017.**