Official Reforms and India's Real Economy*

Sunanda Sen

That the Indian economy is currently experiencing a slowdown is more than evident, both with the deliberations in different private circles and with official statements signalling a series of remedial measures, mostly focussed on the ailing financial sector! However, as we point out, the ailing Indian economy has concerns that go beyond flagging GDP growth and the ailing financial sector.

Downturn in the economy

As for the downturn, the country's GDP growth rate has plunged into a low of 5% in the first quarter of the current financial year 2019-20 .The drop has been accompanied by sharp decelerations in the manufacturing output and a sluggish growth of output in agriculture. Matching both, 'consumption growth' has also been weak.

A fact which remains less highlighted in current official concerns includes unemployment, at 7.1% of the labour force during September-December 2018 as reported in the Labour Force Periodic Review. Unemployment has been even higher for urban youth during the period, at 23.4%. Information as is available indicates on-going spread of job cuts in different manufacturing units and wide-ranging distress in rural areas with farmer suicides, which causes added concern.

There also are recent reports of a shrinkage in labour force participation ratio (the proportion of people who are willing to work), indicating tendencies of withdrawal syndromes on part of the unemployed – which have been largely in response to the grim employment prospects. Distress is further manifested in the large numbers of poverty stricken people - both in rural and urban areas –ranging from 22 % to 29% of aggregate population according to different estimates.

The grim facts relating to unemployment and poverty in the real economy of India make it evident that a drop in GDP growth is not just a matter concerning the dampened financial markets and their volatility. Downturns also speak of the real sector – of the dearth of sustainable jobs and the related poverty.

Looking at the prevailing concerns in India for the stagnating economy, analysts often ruminate on the steep drop in stock prices in India's secondary market which started with the end of the temporary euphoria at end of the national election in May 2019. One may recall the shooting up of the Sensex beyond 40,000 on June 4, 2019, far surpassing 37,000 on May 13. The index, slumping back to a low of 36,855 on August 30, has, at the time of writing, abruptly shot up, nearing 39,000, which is a response to the magic wand of the tax bonanza announced on September 20. Causes cited for the earlier downfall include the volatile net flows of Foreign Portfolio Investments (FPI) - recording outflows of Rs 3,700 crore or above in a single month of July 2019. Above went along with the simultaneous drop on India's foreign exchange reserves by nearly $1 billion between July 20 and July 26, 2019.

Policy measures announced

Concerns relating to the stagnating GDP growth and financial markets in the country has prompted the government to announce a series of measures since the recent official announcements started on August 23, 2019. The measures included a scrapping of the surcharges on long and short term capital gains as were earlier proposed in the last budget; in a bid to help inflows of foreign portfolio investments. A few stimulant measures as suggested include an investment package of Rs 100 lakh crores on infrastructure, a Rs 70 th crore liquidity injection to recapitalise banks and cheaper loans to facilitate property market and auto sector, along with a promise of additional purchases by government departments in auto market. Corporates have also been assured of a no- penalty clause if they fail to comply with the corporate social responsibility (CSR) clause, originally designed to help the underprivileged. Included in the package are also additional roll-backs, of taxes on the 'super rich'- as introduced in the last budget - in income slabs over Rs 2 crore and beyond Rs 5 crore.

Government announcements on August 30, in the next round, relaxed several rules on single-brand retail, contract manufacturing, coal mining and digital media for FDIs. Another important measure has been the dilution of the current 30% domestic sourcing norms for single brand retail trading in the country.

Official announcements on August 30 also related to the mergers of public sector banks, by combining the 'bad' ones with the stronger ones, thus reducing the total number of PSBs to 12. The move is supposed to coordinate with the promised recapitalisation plan of Rs 70th crores, as announced at end of the previous week.

Finally, a big tax bonanza, with rates cut from 30% to 22% has been mentioned on September 30. Above, according to a credit rating agency, Crisil, amounts to a tax savings of Rs 37,000 crores for the 1000 listed corporates. By the same estimates, the expected aggregate tax loss for the government amout to Rs 1.45 crore; which, incidentally, exactly matches the sum received by the government from the Reserve Bank of India. Remedial official measures, addressed to mend the on-going regressive impact of the Goods and Services (GST) tax on the economy, are also on the cards, with several cuts in this indirect tax on specific items.

How effective to revive the economy?

Sops as above as tax relief - to portfolio as well as corporate investors within and outside the country – while effective in temporarily stimulating the secondary stock market, may not work to reverse the tendencies for the stagnation, even in the financial sector and let alone in the real economy. Contrary to what was expected, the initial response of the stock market continued to be rather non-committal over nearly a month between August 23 and September 20th when the big tax bonanza package was announced. It is possibly too early (and nearly impossible) to project the stock market movements in future. Still more doubtful is an expected positive impact of all above policy moves on capacity creation via the market for initial primary offers (IPOs) - short of which there can be no expansion in the real economy of output, investment and employment.

The stark realities relating to the contrasts between the real and the financial economy reflect itself in the low value of the initial Primary Offers (IPOs). As is well known, the latter indicate new physical investments rather than financial transfers alone as in the transactions of shares in the secondary stock market. A revival of the stagnating real economy demands additional investments in physical terms with related expansions in jobs. Little of those are likely to be fulfilled by a boom in the secondary market of stocks and the related gains on speculative and short term investments. Also in terms of simple national accounts, capital gains or losses relating to the portfolio investors in the secondary stock markets are always treated as 'transfers' between parties, and as such not even considered in calculating the GDP in their first round. Possibilities, however, remain of net injections/withdrawals of real sector demand by agents who face capital gains/losses, which deviates from their underlying inclinations to further speculate in the market. However, while the proposed tax benefits will further widen the inequalities within the country, little of those may finally be channelled beyond the speculative zone of stock markets and real estates.

Additions to corporate savings, if generated, will not generate real investments unless demand for the latter is forthcoming in the market. This comes as the home truth that Keynes spelt out more than 80 years back in the context of the Great Depression of 1929-30! Sops to speculation in the market and the lenient tax breaks for super rich as well as corporates may only help to invigorate the current spate of speculation, in stock markets (or even on real estates and commodities) further.

Official concerns as such for the public sector banks sound more than deserving, given the issues with the near bankrupt NDFCs (or shadow banks) with their easy access to the formal banking sector which generated a large part of the on-going NPAs. In our judgement, the vacuum created with shrinking banking facilities and branches and the total absence of development banks will continue to provide space to the NBFCs and their malfunctionings.

Research, as available indicates how the corporates have made use of credit from banks to meet their liabilities (as interest payments on past debt as well as payments of dividends to share-holders), replicating a typical Ponzi strategy. Simultaneously investments by corporates have switched from the real to the financial sector with offers of better earnings on financial securities. Corporates, in the process, also have often taken recourse to bankruptcy while adding further to NPAs held by banks. Finally, NPAs also resulted from the absconding and corrupt clients of banks who could run-away with their liabilities. One wonders if the change in governance as suggested by the recent mergers which aim to combine the weak banks with the stronger ones (in terms of current performance), will help in lifting the PSBs from the current mess.

Incidentally, the soft-pedalling by the RBI with four consecutive cuts in the repo rates, while signalling a nod to expansionary monetary policies, will work to lower the lending rates of banks only if there will be a pick-up of credit demand from the public. And that in turn demands more of investment/consumption demand, especially from the real (rather than the financial) sector. This is because the growth of credit supply is determined by credit demand and not the other-way round! This does not rule out possibilities of additional borrowings at the lower rates to finance speculation in financial markets, which will not help revival of the real economy.

Pattern of stagnation in India's real economy

As already emphasised in the preceding sections of this commentary, a country's GDP growth alone hardly indicates the country's level of development, which include employment, social security and absence of poverty. Recognising above is important in the context of the ailing Indian economy that is currently subject to concerns more pressing than the plunging financial sector.

Mention can be made here of the structural changes in the Indian economy, with changing relative contributions of its three major sectors. Those include the share for services moving up to 50% and above since the early 1990s and the respective industry and agriculture shares stalling around 25% and 19% or less since then.

The employment situation as currently prevail in the Indian economy include 90% or more people struggling to eke out a survival in the informal sector while the organised formal sectors within industry and services offer 10% or less of jobs, thus pushing the majority of the working population to the dark terrains of the unorganised and informal jobs.

As for the sectoral pattern of employment, agriculture has remained the largest provider, at 48.9% of aggregate employment in the economy during 2011-12. Almost all of above are purely in an informal capacity, thus fetching little of the benefits which are usual when labour is formally recruited. As for jobs available in the industrial sector, the organised sector (dealing with the registered factories employing 10 or more workers) provides less than 11% of aggregate employment in the country. Of above more than four-fifths are employed on a purely contractual or temporary basis with none of the benefits that normally accompany formal jobs. A recent estimate points at the low employment elasticity of aggregate output at 0.08%, which today is even lower than 0.18% during 2009-11. Much of the above is due to the lower absorption of labour in the production process due to the use of capital-intensive technology. In addition, growth rates are found to be higher in the capital as well as the skill intensive products - as compared to the average growth for industry as a whole.

The service sector, currently providing more than one-half of the GDP, has only a marginal contribution in employment. Data available from the Labour Bureau indicate that of an aggregate 140-150 million jobs in the services sector during 2015, only 26 million were with the organised sector. The remaining jobs, mostly in petty production units and self-employment, include, in our view, large numbers with disguised unemployment in the informal sector.

Services in the organised sector also include the 'sun-rise sector', comprising of the Information Technology-Business Processing Organisations (IT-BPO). Their contribution to jobs has been rather minimal, as can be expected in terms of their use of capital and skill intensive technology. Growth in India's services sector is concentrated in activities related to finance, real estate and business services (FINREBS). It needs to be noticed that the FINREBS has a rising share, both in relation to the service sector itself, as well as relating to the GDP. In fact shares of the FINREBS not only have escalated over time but have continued to rise, even with declining GDP growth rates. Thus the growth of the service sector including the FINREBS, as can be expected, while contributing to GDP growth, have failed to contribute much in terms of employment or real activity, an aspect which helps to understand the underlying paradox of high GDP growth with unemployment.

The sectoral contributions as above brings home an explanation of the slow growth in jobs and related poverty– and that too for the majority of the labour force employed in the informal sector who are denied of sustainable wages and benefits as well as job security.

Need for an expansionary policy

While there is an urgent need for public expenditure as investments as well as social sector outlays, the Indian government abides by its self-imposed limits on fiscal deficit to GDP ratios, which restrains additional public expenditure. The dictum is provided by the Fiscal Restraint and Budget Management Act (FRBMA) of 2003 which was voluntarily enacted by the ruling government, largely to attract foreign investments. Given that the theory of 'austerity' as a measure of investment revival by controlling inflation is much discredited at levels of analysis and policies, we find no reason why the country should continue to stick to such measures.

It needs to be recognised that official expenditure remains a pre-requisite to stimulation of private spending, especially in the current context of a demand deficient domestic economy as in India. A departure, if effected, from the ineffective policy prescriptions of the mainstream economic theories of fiscal restraint can be expected to generate a climate of expansion within the country.

Considering the gravity of the situation, this is the moment for a call to the state to act and not just protect finance capital which include the speculators who operate in stock markets, the super-rich who are disgruntled and pose the threat to move offshore to avoid the newly imposed surcharges on higher income slabs, to provide relief to the bankers misallocating funds in search of quick and illegitimate gains, or even to protect and incentivise the corporate sector, the former for a negligence to the much too small a benevolence they were subject to in terms of their obligations to fulfil the CSR, and the latter as investment inducements.

We can conclude that it will be a limited exercise on part of the officialdom to view the financial market performance as a true gauge of performance of the economy as a whole.

Indeed, the Indian economy is in dire need for an alternate course of action. The state must focus and restore the real economy with channels to revive investment, employment and other social goals for the majority.

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