Ways out of a crisis

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This article is related to General Studies-Paper-III (Indian Economy)

Indian Express

5 Dec., 2019

"The current economic slowdown needs a multi-pronged response."

India's economic growth (gross domestic product) was at 4.5 per cent in the second quarter of the current financial year. Gross Value Added (GVA), which is actually more representative of economic activity, grew at 4.3 per cent. The second quarter growth is the weakest since the fourth quarter of FY13.

There are distinct features of the current slowdown which make it different from the ones in the past. First, multiple growth engines — consumption, investment, exports, credit — have all slowed down synchronously; earlier, one of these engines would offset the weakness in the other. As in the first quarter, the proximate source of the slowdown was the manufacturing sector. But, underlying this is a sharp deceleration of investment spending. The growth drivers were also quite concentrated, with a prominent source being government spending.

There was a modest revival of household consumer spending, but this might also be an outcome of high government spending.

Second, the previous slowdowns were more the result of supply shocks, while this one seems to be led predominantly by a weakness in demand. While the focus has been on the real growth slowdown, even more striking is the slowdown in the nominal GDP growth rates. Reflecting the changing dynamics of volume growth and inflation over the past three years, nominal growth halved to 6.1 per cent in Q2FY20 (over the same quarter a year back), compared to a drop of 2.5 per cent in real growth. This is a matter of concern since nominal growth shapes the behaviour of economic agents, consumers, savers and investors. Equally, this has implications for the policy response since multiple economic variables depend on nominal growth — for example, the most immediate effect is in the slowdown of the Centre's tax revenues.

The services sector has held up better than manufacturing. While the industry growth dropped from 10 per cent in the June 2018 quarter to -0.5 per cent in Q2, the services sector only modestly decelerated from 7.5 per cent to 6.4 per cent. The concern regarding this persisting deceleration is of the manufacturing slowdown spilling over to the services sector, both in construction and particularly in transport, where the weakness is evident both in data and anecdotal evidence. From the demand side of national accounts, private consumption growth is likely to be as low (or lower) as the first quarter based on public data like auto sales and results of service companies.

Third, the earlier slowdowns seemed to be led by the real sector. This time, the problems seem to have originated in the financial sector and then spilled over to the real sector through mechanisms similar to Ben Bernanke's model of a financial accelerator. The credit squeeze has played a large role in amplifying the factors decelerating consumption and investment. The RBI data showed a striking drop in the flows of funds from multiple lending channels, from Rs 7.4 lakh crore in April-September 2018 to Rs 91,000 crore in the first six months of this year. Bank credit growth has dropped to 8.5 per cent in October. How does policy respond to this situation? A clear path for a revival in growth is not immediately obvious. The second quarter growth was most likely the bottom, yet the initial signs of a revival in the third quarter are modest.

Monetary policy was the first responder, with multiple repo rate cuts, adding up to 1.35 percentage points and another possible cut in the ongoing meeting. Due to multiple reasons, including a large liquidity deficit till June that kept the cost of bank deposits high, transmission of these cuts into bank lending rates was limited. However, the emergence of surplus liquidity since July has accelerated the pace of cuts in fixed deposit rates, and increasingly into bank lending rates. The quantum of rate cut in this MPC meeting, and the communication on the scope for further cuts, as well as the growth and inflation forecasts will also guide lending rates.

To start a virtuous cycle of a revival of consumption-led demand for increasing capacity, government spending is crucial given the weakness in private sector demand. In coordination with monetary policy, the government should actively pursue a counter-cyclical fiscal stimulus though a large stimulus is constrained by weak tax buoyancy. A revenue source which is being aggressively explored is disinvestment. This might offset some of the tax revenue shortfall. Further, as of FY18, almost Rs 9 lakh crore of various tax dues were stuck, of which about Rs 7.8 lakh crore were under litigation. This pipeline needs to be quickly unclogged, even if it means larger haircuts for the government in interest and penalties.

The other fiscal stimulus which also needs to be accelerated is making expenditure more efficient through targeting delivery, plugging leaks, and rationalising overlaps in spending. The FY20 Budget had an "Output Outcome Framework" for the first time with metrics for evaluating outcomes of government spending. In tandem, accelerating securitisation of operational revenue generating toll and other road projects and using these funds and other offshore sourced investments to finish projects like the dedicated freight corridors and increasing spending on the Pradhan Mantri Gram Sadak Yojana will serve as an investment and growth multiplier.

Some calculated risks in micro-prudential relaxations of regulatory norms for bank lending to stressed sectors will add to the measures designed for reducing risk aversion in bank lending. The Centre's proposals for a partial credit guarantee for pooled assets of NBFCs and a fund for last mile finance of incomplete residential projects need to be quickly operationalised.

The signature message from the October monetary policy was the decision to "continue with an accommodative stance as long as it is necessary to revive growth". This understated statement — equivalent of the European Central Bank's President Mario Draghi's commitment to do "whatever it takes" in 2012 — should be the guiding imprimatur of policy communication.

Expected Questions (Prelims Exams)

1. Consider the following statements–

1. There has been 4.3 percent growth in Gross Value Added in the second by monthly report of current financial year.

2. The fall in the service sector is one of the main reason for the current slowdown.

Which of the above statements is/are correct?

(a) Only 1

(b) Only 2

(c) Both 1 and 2

(d) None of the these

Expected Questions (Mains Exams)

Q. Review the possible measures available to the government to overcome the ongoing slowdown in the Indian economy. **(250 words)**

Note: Answer of Prelims Expected Question given on 4 Dec., is 1 (d).