Understanding the

Indian Economic Slowdown-

What, Why and How?

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India, that once had a tag of the fastest growing economy of the world, reached to the second position with GDP growth rate of 5.8%, when CSO released its quarterly data in June 2019. In the first quarter of FY 20 GDP further slowed to 5% .China grew at 6.4% in the June 2019. The real GDP has in-fact fallen from a peak of 8.2% in 2016-17 to 6.8% in 2018-19.In order to understand the slowdown in the Indian economy, we can start by understanding the components of Gross Domestic Product (GDP) which is defined in economics as the market value of all final goods and services produced by an economy within a period of one year. It is not only the falling GDP figures but - the rising unemployment, a crisis like situation in the auto sector, liquidity crisis in financial sector, falling rural and urban demand, slowing private investment, looming trade war tensions between US and China and its possible ramifications on global economy and falling revenues for the Indian government are the various causes of worry for the Indian government.

I. GDP and its Components

GDP = C+I+G+(X-M)

C stands for Private Consumption expenditure. It is the expenditure on consumer durable goods & single use goods. It has been accepted by economists that Consumption is the 'turbo' of India's growth engine owing to huge middle class in the country (comprises of 28% of India's total population as per a study based on the IDHS data). The consumption expenditure in India has been declining, becoming a cause for worry. This is evident by a softening of growth in the FMCG sector to 11-12 %, about 2% lower than in 2018; as reported by Neilson, a market research agency. The y-o-y percentage change in 'Private Final Consumption Expenditure' and private consumption expenditure as a percentage of GDP, both show declining or more or less stagnant trend (Private consumption expenditure as a percentage of GDP fell from 56.6 % in 2013-14 to 55.7% in 2017-18).

There are enough evidences to prove the point that Indian households are not spending anymore. The sales of cars, two wheelers etc. The FMCG giants like HUL and ITC has been talking of sluggish rural and urban demand, hinting that this time unlike the recession of 2008; it is a demand side problem.

Besides this, other indicators of consumption like passenger vehicle sales, two-wheeler sales and domestic tractor sales - all recorded negative growth rates in the first half of 2019. Only domestic air traffic showed positive growth of 3.15% during Jan -July 2019, however it is very less compared to growth of 21.7 % during the same period in 2018 and 17.18 % in 2017.

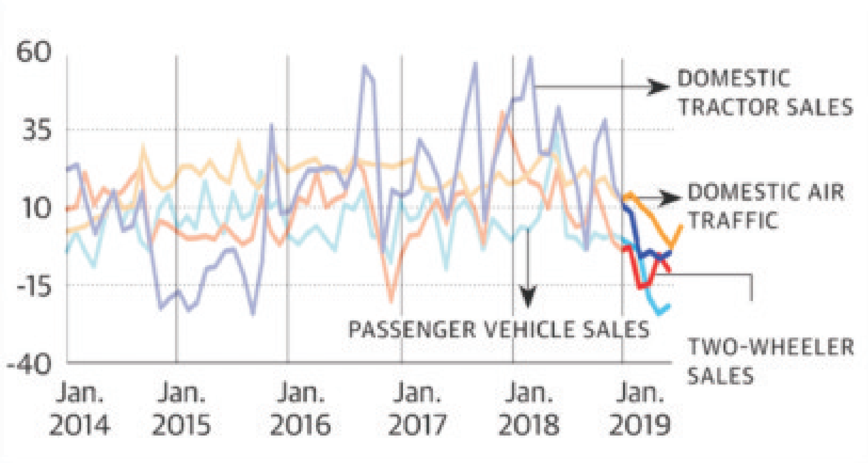

Figure 1: Some Indicators of Consumption

Source: The Hindu, August 6, 2019

Considering that the Consumption sector contributes almost 60 % to GDP and its quite obvious that fall in consumption will impact GDP growth rates negatively.

I stands for Investment expenditure or "Gross Domestic Private Investment". It is the expenditure made by private enterprises on new investment & replacement of old capital. This other component of GDP, really needs focused attention at this time- especially the private sector investment. Public investment of Rs. 738.4 billion in the quarter ended in March shows a nearly 62 % decline from the last year. Similarly, the Gross Fixed Capital Formation to GDP ratio showed a very minor increase from 31.1% in 2016-17 to 31.4% in 2017-18. The share of Private investment in total investment in economy has been steadily falling from 2014 and now stands at 47% in 2018-19, thus indicating that it is only the government investment or expenditure which was dragging the GDP along.

There are several factors that motivate businesses to invest. Initiatives like easing of controls and regulations for new businesses, FDI reforms, infrastructure development, Insolvency and bankruptcy Code, implementation of GST have been taken by the government since 2014 to encourage investment, especially in the manufacturing sector. However, there has been no significant improvement in the investment and business climate.

G refers to the government expenditure or government spending on purchase of goods and services. It includes different kinds of government expenditures like infrastructure spending, spending on public welfare schemes, payment of wages and salaries to government employees, military spending etc. During times of recession/economic slowdown, the economy is characterised by negative business sentiments with people and private institutions curtailing investments. This,in fact gives rise to a vicious cycle which is detrimental to income and employment generation required to boost demand in the economy. Hence, during such times when private investment is not forthcoming, it is the government expenditure that can fill in for it and help start a virtuous cycle of investment - production - income - consumption. More so, when there exists unutilised production capacity in the economy.

The government spending in India decreased in 2019 as compared to 2018 and in 2019 it has increased only meagrely to 3686.66 INR billion in first quarter of 2019 from 3411.26 INR billion in the fourth quarter of 2018.

Figure 2: Government Expenditure in India

Source: Tradingeconomics.com

The last component of GDP is (X-M) which refers to the net of income earned from abroad. Expressed in terms of goods and services it means the net of exports and imports. India has traditionally not been an export oriented economy unlike many of the other emerging Asian economies like China. Hence, this component of GDP cannot be looked at as a ray of hope in entirety. More so, the export figures for Indian economy, have never been too encouraging.

India's exports had peaked at $ 314.88 billion in 2013-14, declined to a low of $262.2 billion in 2015-16 before recovering partially to $303.3 billion in 2017-18.

The above analysis of GDP clearly explains the reasons why we have falling GDP figures pointing to an economic slowdown. The government initially in denial due to 2019 being an election year. On the evening of 31st May 2019, the Ministry of Statistics released the quarterly data on Indian economy on and that became a sort of validation of the news channel debates and newspaper editorials that were beset with arguments for a slowdown of the economy.

II. GDP Projections

Following the release of government data, many agencies cut down the growth forecast for Indian economy. International Monetary Fund (IMF) cut India's growth forecast for FY 20 to 7%, Asian Development Bank also cut the growth outlook for FY2020 to 7%. More recently, Fitch Ratings - one of the three big credit rating agencies of the world; cut its forecast for Indian economy to 6.8% from its previous estimate of 7% and Morgan Stanley also cut the growth forecast to 6.3 % from the previous forecast of 6.5%.

III. Cyclical Vs. Structural Slowdown

Therefore, now there is no denial that can take place on part of government as far as the current economic situation is concerned. However, the debate amongst economists on whether the current slowdown is structural or cyclical in nature is not settled in any way. A cyclical slowdown occurs when the economy has supposed to have crossed the peak of economic activity and then faces a downturn by virtue of the operation of the business cycle. On the contrary, a structural slowdown is indicative of some deeper problems in the economy that hinders in free and efficient production of goods and services. To correct a 'Structural slowdown' government would require making radical changes to effect demand, investment etc. The arguments have been tilting in favour of a structural slowdown because one after another the indicators are showing signs of declining economic activity in the economy. For example, in FMCG sector both rural as well as urban demand is slipping, the new investment projects being announced are declining, projects being stalled are increasing, the Gross Domestic Savings as a percentage of GDP (which drives private investment) has fallen to 29.3 % in 2018 from 32.7% in 2011, the growth rate of 8 core sectors (coal, crude oil, natural gas, refinery products, fertiliser, steel, cement, electricity) of the economy dropped to 0.2 % in June 2019. A structural slowdown definitely needs some radical changes by the government to improve business and consumer sentiments, and increase spending as well as investment. According to a recent study by State Bank of India, "the reasons for the current slowdown are both structural and cyclical in nature, apart from the global uncertainties"

IV. Two Ways of looking at the problem - Demand Side and Supply Side

Demand Side Problem: The current economic slowdown has started through a demand side problem evident by fall in consumption.

(a) NBFC Crisis -

The lower consumption intensified by the liquidity crisis in the NBFC sector was

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[1]*Making Sense of NBFC Puzzle Box, Live Mint , June 16, 2019*

triggered when one of the biggest infrastructure lender, Infrastructure Leasing and Financial Services (IL&FS) began defaulting on its obligations since June last year. This led to the unprecedented liquidity crisis in the Non-Banking Financial Sector (NBFC). The NBFC sector's funds were stuck in the IF&FS debt instruments and defaulting of IL&FS obviously put them under strain - creating liquidity crisis as also solvency crisis. Solvency crisis means that the NBFCs were now in danger of defaulting their payments to banks which have been a major source of resources for NBFCs. The NBFCs were actually the largest net borrowers from the financial system with gross receivables of around Rs. 419,000 crores and gross payables or loans to the tune of 717,000 crores in March 2018. Out of the total funds, the sector received the highest of 44% from the banks. Now that NBFC sector is facing a solvency crisis, the banks are weary of lending them and Housing Finance Companies (HFC). The liquidity crisis in NBFC sector led to reduced lending to various sectors of the economy like auto, real estate, FMCG sector etc. thereby impacting demand and consumption. This sector was a major source of finance for durable consumer goods like cars, TVs, household appliances besides real estate. As reported in a 'Mint' article, responding to the NBFC crisis, S.S Mundra, former deputy governor, RBI said "We cannot take the NBFC crisis lightly. This kind of event will force the industry to change structurally," "They won't be able to clock the same kind of growth and margins would also be compressed going forward. Hence, investor interest would see a change". In subsequent months, this was evident in the tightening liquidity conditions in the entire financial system of the country. It also impacted the transmission mechanism of monetary policy. Even though, the Reserve Bank of India successively reduced repo rates 4 times, the benefit of reduced repo rates was not passed on the consumers in the form of reduced lending rates. This happened because the banks and financial companies were scared to reduce the deposit rates, thereby not allowing the marginal cost of lending to come down too.Bringing relief to the sector, the government announced several measures to infuse liquidity and give some relief to the NBFCs in the 2019-20 Budget.

(b) Declining Wage Growth and the Rural Demand-

The growth in urban wages in India peaked at 20.5% in 2010-11 and then went down to single digit in 2018-19. Similarly, the growth in rural wages peaked at 27.7 % in 2013-14 and reduced to below 5 % post 2017. A RBI Working Paper titled "Rural Wage Dynamics in India: What Role does Inflation play" demonstrated that rural wages growth fell after a phase of acceleration after 2014. This period was marked by low inflation that occasionally went above growth of real wage leading to negative real wage growth.

The rural incomes were also adversely impacted by the low inflation that Indian economy has witnessed in recent years. Core inflation or non-food and non-fuel inflation has been falling since last year and retail inflation (that RBI factors to calculate monetary policy rates) is also below 4 percent. This regime of low food inflation has actually eroded farmer's incomes.

Besides this, we have also seen that household savings in India have been coming down in the recent period. This is also reflective of the fact that consumer's income are not increasing.

Hence, we have seen the demand deficiency in the economy, due to which there is a danger looming large on reduction of production, investment and jobs.

(c) **Adverse Impact on Jobs in Several Sectors-**

The aggressive attempts to formalise Indian economy that have been taken up by the government of India - including Demonetisation and GST have actually impacted adversely the demand in the economy that existed due to unaccountable incomes. Post demonetisation, small traders and businessmen in sectors like manufacturing and construction that mainly dealt in cash were adversely impacted which led to reduction in their businesses and incomes.The crisis in auto sector may also lead to massive job losses. The big auto brands like Maruti Suzuki, Mahindra & Mahindra, and Hyundai Motors have all reported a decline in sales. Maruti Suzuki India recently reported a sixth consecutive month decline in sales by 33.5 percent in July 2019. Hyundai Motor India sales fell by 3.8 percent in the same month. Similarly, Honda India and Mahindra & Mahindra too reported a decline in sales by 48.7 and 15 percent respectively. All types of vehicle sales including two -wheelers have seen a decline. These numbers clearly point out to the fact that the auto-biggies may resort to retrenchment of temporary and contractual labour in response to reduction in sales and piling up of inventories. Though there are certain other factors responsible for the slowdown in auto sector, but the impact on jobs shall definitely be adverse.

A lot of jobs that were being generated in the construction sector have also been showing a downward trend. Construction has been one of the top job generators in India in the non-farm sector. It had registered a handsome growth of 12 % in the past half-decade till the sector lost steam in the last fiscal. However, the productivity in the construction sector has been falling and was almost equal to that of the farm sector in recent times. The slowdown in the construction sector has a multiplier effect on other related industries like cement, iron & steel, real estate etc.

In order to arrest such downward trend of job creation and growth in construction sector, the government should pump in more money through investments in infrastructure sector, which the governments is committed too. It was announced in the Budget 2019-20 that investment of 1 lakh crores is planned in the infrastructure sector over a period of 5 years. Also, private investment should be encouraged in these sectors. Hopefully, the government investment will result in 'crowding -in' of private investment.

Supply Side Problem: The supply side problem points to issues that lead to lack of supply in the market. It is considered to be a structural issue and economists recommend factor market reforms like labour reforms, land reforms, improving capital access etc. to address the issue.
The shadow banking in India took a hit with the NBFC crisis, banking industry was also facing liquidity crunch due to rising NPAs and monetary transmission had not been as smooth as required.

The private investment has also been declining for a while now. It started falling in the last two years of UPA government. Among other factors responsible for the same, one was recognised as 'policy paralysis' which was a catchphrase often used to refer to the government's indecisiveness as far as economic policy was concerned. This is indicated by a declining Investment to GDP ratio. All these issues led to limited access to credit and its high cost, which ultimately impacted credit to several sectors.

V. Remedial Measures -Structural Changes; Booster Shot Via Monetary and Fiscal Policies

The government has taken a number of steps since the data on growth and jobs was made public in May 2019. Many of the unpopular announcements were also rolled back by the Finance Minister on August 23 2019 during her press conference that was held a day after the famous rating agency Moody's cut India's growth forecast for 2019 to 6.2 % from previously 6.8%.

Government as well as the Reserve Bank of India are focusing on several aspects of the current economic problem with an objective of doing the balancing act of adhering to the fiscal discipline with strict fiscal deficit target of 5.2 % for FY 20.

(a) Monetary Policy Stance -

The RBI has been cutting repo rates since last 4 times. On 7th August 2019, the rate was reduced to 5.40 %. Cumulatively, RBI has reduced 100 basis points since February 2019. However, the transmission of rates for consumers by the banks has not been smooth. It is only recently that banks have started reducing their lending rates. The banks were finding it difficult to reduce the rates because it was difficult for them to reduce their deposit rates which are mostly fixed. Also, floating interest rates on the time deposits are not acceptable to Indian depositors.

The difference between deposit and lending rates is the profit for banks. If it's difficult to reduce the deposit rates, lending rates too, remain sticky. On 4th September 2019, the RBI has directed the banks to link interest rates on loans to retail and small borrowers to an external bench marking from 1st October 2019 to help in effective downward transmission of interest rates. Hopefully, more banks will now pass the benefit of repo reduction to the consumers that would eventually lead to investment and purchase of consumer durables.Going forward, the Reserve Bank of India is expected to continue with the easy money policy meaning that it is likely to reduce the repo rates till inflation is well within its target limits. Many economists are expecting a further 25-35 basis point cut in RBI's benchmark rate in October 2019.

(b) Reforming Banking Sector

The Finance Minister committed to undertake further recapitalisation to the tune of 70,000 crores of public sector banks in the Budget announcements made on 5th July 2019. The banking sector's condition had improved to an extent before the NBFC crisis hit the sector due to recapitalisation of banks by 3 lakhs 11 thousand crores over the past 5 years. The NPAs which were 11.2 % of the total loans in 2014 had come down to 4.3 % in 2017 and 3.8% in 2018.

Recently, RBI released 1.76 lakh crores to the government as dividend and a part of excess reserves on recommendations of the 'Bimal Jalan Committee'. This has given room to the government to undertake bank recapitalisation as planned.

In a bid to reform the sector, the finance minister has also announced merger of banks recently.

(c) Generating Resources to fund government expenditure

This is important as the government has to generate funds with low pay back liability in order to spend and also meet the fiscal deficit target. In the budget, an idea of issuing 'Sovereign Bonds' - it was suggested that if government would fund some of its requirements from loans taken from outside India, there will be investible money left for private companies to borrow and also interest rates will start coming down. However, due to opposition from several quarters, the government is not going ahead on this agenda. The alternative that remains with government is disinvestment. The government has ambitiously set up a record disinvestment target of 1.05 lakh crores in the budget. If successfully completed, the government would have reduced its stake in many Central Public Sector Enterprises to below 51%. Though this would generate resources but government should move cautiously on this issue. These enterprises have immense value and before resorting to desperate sale of these assets, government should take into account viewpoints of different stakeholders through careful deliberations and debate.

(d) Encourage Private Investment

In order to encourage private investment, the government has sought to increase the 'ease of doing business' by undertaking labour reforms, lowering of interest rates, scrapping the angel tax and super rich tax, giving relief to Foreign Portfolio Investors, decriminalising violation of Corporate Social Responsibility (CSR) etc.

Apart from these measures, the government is holding stakeholder discussions with several industries to understand their concerns and instil business confidence in the economy.

(e) Ease Liquidity Conditions for MSMEs

For ease of access to credit for MSMEs, the government has introduced providing loans up to 1 crores for MSMEs within 59 minutes through a dedicated online portal. Under the 'Interest Subvention Scheme' for MSMEs Rs. 350 crores has been allotted for FY 2019-20 for 2 % interest subvention for all GST registered MSMEs. Also, to encourage MSMEs, pension benefit to 3 crore retail traders and small shopkeepers has been introduced. This benefit shall be available to all shopkeepers whose annual turnover is less than 1.5 crores - under the 'PM Karam Yogi Maandhan Scheme'.

However, these measures are not enough. In fact, the banks in India should be encouraged to adopt innovative lending methods to increase financial access to MSMEs. In many emerging countries of the world, the banks are innovating to compete with the new fintech firms that are giving fierce completion to traditional banks. However, the fintech companies have yet to prove the sustainability of their models. A mid-way approach whereby banks and fintech companies can collaborate and work towards reducing the obstacles to access of formal finance by MSMEs.

(f) Measures to Boost Demand

Since the current slowdown mostly appears to be a demand side problem, this is the most important aspect that must be looked into by the government. Boosting demand basically means taking measures to increase the disposable income in the hands of people so that they can spend the same in the market. Be it fall in auto sales or sluggish demand in FMCG - there are enough evidences for a demand deficit in the economy. Since the jobs are drying up and there will be some amount of retrenchment in some sectors, clearly the private sector is not generating demand. As of now the government should try to kick start the cycle of consumption -investment - production by increasing people's incomes. This is important because during times of sluggish demand and production slump, things can worsen faster than one could imagine. A ‘wait and watch' approach at such times is dangerous. A fair way of encouraging demand can be that government increases minimum wage, complete vacant positions in government offices, reduce tax rates, dole out compensations in line with what was being done through MNREGA etc.

On September 15th 2019, the Finance Minister made an announcement to encourage spending by Indian middle class and revive the real estate industry from the impending slowdown - the government would create a Rs. 20,000 crore fund by contributing Rs. 10,000 crores and expecting an equal contribution from outside investors. The primary objective is to kick start stalled housing projects in affordable and middle class housing segment. This is a positive effort as it would bring some cheer to the real estate sector as well as help projects (which have not yet been declared as Non-Performing Assets (NPAs) or fallen into litigation) to delivered to the buyers. Also, in order to encourage the export sector, the government has decided to expand the scope of Export Credit Guarantee Corp (ECIS) and offer higher insurance cover to banks that lend working capital for exports.

Such measures to boost sectors struggling with slowdown and to increase people's incomes are part of the Fiscal measures to fight the impending recession. These must improve the presently gloomy sentiment in the economy and lead it on path to recovery.

The optimistic yet achievable target of making India a 5 trillion economy in near future is only possible if economic activities increase at a fast pace with kick from private as well as public investment, positive business sentiment, ease of doing business, investments in infrastructure along with investments in health and education.

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