

Economic Revival or Dead Cat Bounce?

ALOK SHEEL

Although growing at rates that are globally enviable, the Indian economy has been unstable over the last several years. False dawns, shifting time series, and the selective use of data has provided fodder for scoring political brownie points. Citing near-term data, the *Economic Survey 2017–18* argues that the Indian economy is on the path of recovery even as it raises some red flags. What does a comprehensive appraisal of the data show? Is this “recovery” sustainable or is this yet another case of a dead cat bounce?

A great deal of heat and dust is being generated currently over recent economic growth trends in India. Much of this is unfortunately rooted in political debates drawing predetermined conclusions cherry picking data. Although the *Economic Survey*, brought out as it is by the treasury, cannot be expected to rise fully above this din and noise, it is perhaps a government document that comes closest to this.

First, it cannot paper over inconvenient facts as it presents and updates the raw data each year in a comprehensive manner. Second, it is prepared by that wing of the finance ministry that consists entirely of trained economists, usually headed by a renowned, and increasingly, globally renowned, economist as the chief economic advisor. Under their stewardship the *Economic Survey* has been transformed from a dismal, boring official survey of the financial year drawing to a close, to an eminently readable narrative that showcases the Economic Division’s own recent research using data not easily available to researchers. On the basis of this research, last year’s *Economic Survey* highlighted eight “interesting facts” about the Indian economy, while the current one highlights 10 “new” facts.

The *Economic Survey* comes in two volumes, which include a broad overview, detailed sectoral reviews, and a very useful statistical appendix that brings long-term series data relating to the Indian economy up to date. It is, therefore, an invaluable source material for economists calling for critical appraisal.

Medium-term Growth Trends

The popular narrative is that economic growth towards the end of the second term of the United Progressive Alliance (UPA) was lacklustre. From a rate touching double digits, beginning from the second quarter of 2011–12 it appeared to

spiral to almost 12 successive quarters of declining growth, including several quarters of sub-5%. There was rapid deterioration in the twin (current account and fiscal) deficits. Consumer price inflation settled into double digits. There was a decline in both savings and investment, particularly in financial savings, as savers rushed to buy gold to hedge against inflation. The decline in growth was out of proportion to the decline in investment as productivity fell on the back on mounting infrastructural bottlenecks and failing governance.

Then, within the space of just one year there was a change in government, and change in the base year for national income and price series. The new gross domestic product (GDP) series indicated that growth had been underestimated, that the economy had bottomed out at 5.6% in 2012–13, and had started recovering thereafter, growing at 6.5% in 2013–14 (last year of UPA-II) and 7.1% (later revised upward to 7.4%) in 2014–15, the first year of the new government. The economic winter had suddenly turned to spring, and midsummer appeared to be approaching, with growth climbing to 8% in 2015–16. There was a dramatic improvement in key macroeconomic variables, such as the twin deficits and consumer price inflation. The Bombay Stock Exchange Sensex rose spectacularly from an annual average of 9% in 2013–14 to a dramatic 30% in 2014–15.

As the new government took office in 2014–15, it confidently asserted in its first *Economic Survey*:

A political mandate for reform and a benign external environment have created a historic moment of opportunity to propel India onto a double-digit growth trajectory. Decisive shifts in policies controlled by the Centre ... could cumulate to Big Bang reforms. ...

... India has reached a sweet spot—rare in the history of nations—in which it could finally be launched on a double-digit medium-term growth trajectory. ...

This opening has arisen because facts and fortune have aligned in India’s favour. The macro-economy has been rendered more stable, reforms have been launched, the deceleration in growth has ended and the economy appears now to be recovering, the external environment is benign, and challenges in other major economies have made India the near-cynosure of eager investors. (*Economic Survey 2014–15*, Vol 1, p 1)

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The Dead Cat Bounce

There was understandable scepticism in some quarters regarding the new narrative, including within the central bank. This seemed out of sync with several high frequency economic data, such as the index of industrial production (IIP), bank credit growth, exports, as well as corporate profits, savings, and investment. The improvement in macroeconomic fundamentals also seemed fortuitous, on account of declining international oil and food prices, rather than structural shifts, as exports continued to decline and the agrarian economy was unchanged.

There was, moreover, a danger that policymakers might become complacent and lose the urgency to leverage the “sweet spot” to address the obstacles in the way of a sustainable recovery to a high growth trajectory. *Economic Survey 2015–16* (Vol 1, p 1) observed:

This year's Economic Survey comes at a time of unusual volatility in the international economic environment. Markets have begun to swing on fears that the global recovery may be faltering... Amidst this gloomy landscape, India stands out as a haven of stability and an outpost of opportunity. Its macro-economy is stable, founded on the government's commitment to fiscal consolidation and low inflation. Its economic growth is amongst the highest in the world.

This refrain was carried forward into *Economic Survey 2016–17* that observed:

Against the backdrop of robust macro-economic stability, the year was marked by two major domestic policy developments ... The GST will create a common Indian market, improve tax compliance and governance, and boost investment and growth; it is also a bold new experiment in the governance of India's cooperative federalism ... These actions would allow growth to return to trend in 2017–18, following a temporary decline in 2016–17. (p 1)

But growth continued to decline, falling to an estimated 6.5% in 2017–18, the level at which it had bottomed out in 2013–14. The recovery was a classic illustration of a dead cat bouncing after hitting the floor. From being the “haven of stability” in a turbulent global economy, the *Economic Survey 2017–18* admits to a “temporary decoupling” with what was now a robustly growing global economy. According to the International Monetary Fund's (IMF) World Economic Outlook

(WEO) update of January 2018, global growth rose from 3.1 % in 2015 to 3.2% in 2016 and 3.7% in 2017. During this period, advanced economies expanded at 2%, 1.7% and 2.3%, and emerging market and developing economies (EMDES) at 4%, 4.4% and 4.7%. Growth in India, however, declined from 8% to 7.1% and further to 6.5% respectively in the same years. The reasons for this decline are, consequently, entirely domestic.

The Four Horsemen

India remains one of the fastest growing major economies, but also the poorest. On the one hand, it is in a demographic sweet spot where additions to the labour force exceeds the population growth rate. This enables it to have the highest growth potential amongst its BRICS (Brazil, Russia, India, China and South Africa) peers, and accelerated income convergence with high income economies. On the other hand, it also has the lowest per capita income amongst its BRICS peers. The upshot is that it has a lot of catching up to do. It needs to grow near its high growth potential over several years to absorb the large additions to its labour force, and to become a major economic and political force anywhere near its civilisational peer, China. India has underperformed significantly relative to China over the last four decades. Their per capita incomes were on par as late as 1980. China's per capita GDP is now almost five times higher at nominal prices, and over two times at purchasing power parity.

Economic Survey 2017–18 observes that catching up with high income countries is getting harder for low income countries like India than it was for the early convergers in East Asia and Europe. This is on account of the “four horsemen” on the horizon, drawing on an analogy from the biblical Book of Revelation. The first horseman is the retreat from hyper globalisation that queers the pitch for exported strategies of growth. The second horseman is “thwarted structural transformation,” wherein resources and labour are unable to make a rapid and seamless shift from the low productivity informal sector to high productivity modern sectors, as envisaged in the Arthur Lewis model,

and instead shift to only marginally more productive sectors. The third horseman is “human capital regression,” with technological advancements making it increasingly difficult for late convergers to transit to the new human capital frontiers on the scale required for structural transformation. The fourth horseman is climate change-induced stress that has queered the pitch for the rapid productivity shifts in agriculture necessary for the release of resources for the modern sector.

Presumably, these structural impediments are to be distinguished from the “temporary decoupling” that *Economic Survey 2017–18* attributes mostly to the twin shocks of major structural reforms, namely demonetisation and the introduction of the goods and services tax (GST), that are however, expected to raise and sustain growth over the medium- to long-term.

This overlooks an important fact. A large proportion of economic output and employment, as in most low income developing countries, comes from the difficult-to-measure “informal,” low income generating petty production sector, which mostly falls outside the tax and social security nets. It has long been known, from at least as early as the days of Arthur Lewis, that economic development entails a shift to a sustainable high growth trajectory through a shift of economic activity and employment from this traditional sector to the more productive and capital-intensive modern sectors of the economy. Historically, this entailed the putting out of petty production as it was absorbed in the fast-expanding modern sectors as part of industrialisation. Such formalisation also ensures that a greater proportion of economic activity seamlessly enters the tax and social security nets.

Statistical data is hard to come by for the traditional sector, by definition informal and unorganised. There is, however, a fair degree of consensus (deriving from anecdotal evidence) that while both demonetisation, and the hasty manner in which GST was implemented, contracted economic activity overall (as the *Economic Survey* has noted), the petty production sector was affected disproportionately. This is because it operates entirely through cash, and has neither

the skills nor resources for elaborate record-keeping.

The *Economic Survey* presents data on the greater formalisation of the economy as a result of demonetisation and GST. This data shows that a large proportion of units and workers nevertheless remain in the informal sector. It is widely feared that many such small units may have been put out altogether, not through a virtuous absorption into the more productive “formal sector,” but on account of administrative shocks like demonetisation and GST. It did little to improve productivity and incomes while increasing their overheads and due diligence. These shocks occurred at a time when formal sector economic activity, and private investment, was shrinking, queering the pitch for the crossover to the modern sectors.

If this is indeed the case, the economy may have lost more output than what advance estimates for 2017–18 indicate. This is because the benchmark-indicator method draws upon formal sector data

to make projections for the informal sector output. Indeed, these events may have shifted the structure of the Indian economy in a manner where some of its output potential has been lost. The second horseman may have already struck.

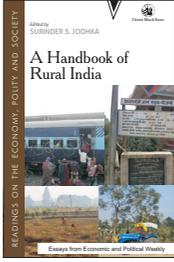
High Frequency Indicators

Has the Indian economy finally turned the corner or is it another case of the dead cat bouncing?

The big difference between the revival of GDP growth following the introduction of the new GDP series and the present revival is the consistency with high frequency indicators. It is to these green shoots that the *Economic Survey 2017–18* draws attention while estimating that the economy will grow in the upper ranges of 6.5%–6.75% in 2017–18 and 7%–7.5% in 2018–19, more or less on a par with the projections in IMF’s latest WEO update of January 2018.

Recent export, industrial production, and bank credit growth data are encouraging and could indeed herald a more

durable recovery. There are however indications that the recovery is likely to be tepid, rather than v-shaped, where a short period of above-trend growth on a low base recoups the output lost during the downturn, and the productive capacity of the economy remains intact. A prolonged period of low and unstable below-trend growth on the other hand leads to a permanent loss of output, and can also lower potential output through hysteresis. A return to double-digit growth hoped for in the *Economic Survey 2014–15* is unlikely any time soon, and indeed appears to have been given up, despite the return of a favourable external environment. First, the growth rates of high frequency indicators are significantly lower than what they were during the earlier high growth period. Second, these relatively modest growth numbers come on a low base of several quarters of poor or negative growth. Third, there is little in the survey to suggest that the declining trend in savings and investment, and the fast mounting bad assets of Indian



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SURINDER S JODHKA

“Rural” and “urban” are the foremost categories through which social life has been visualised and engaged with in modern and contemporary times.

The idea of the “rural” or the “village” has been of particular significance in India. British colonisers represented India to the world as a land of “village republics”. This representation was so influential that even the nationalist leaders accepted it uncritically.

Gandhi advocated “a return to the village” as the only genuine way to gaining *swaraj*, or self-rule. Nehru and Ambedkar too saw the village as the site of India’s traditional life; however, to them it was also a signifier of India’s economic backwardness and social ills. These notions have shaped social science scholarship, popular politics and public policy.

The idea of such a demographic transition continues to be a core element of state policy and an important indicator of positive social change and economic growth/modernisation. However, the “rural” in India persists; nearly two-thirds of India’s population still lives in rural settlements.

A Handbook of Rural India brings together 36 research papers published in the *Economic and Political Weekly* which were written by some of the leading social scientists from the early 1950s to the present. It provides a historical perspective on the subject of the “rural” and covers a wide range of topics that have been critical to the imaginings and empirics of village life in contemporary India.

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banks, critical to any sustainable recovery, have been arrested.

Monthly industrial production grew consistently between 8% and 15%, and on occasion touched 20%, during the economic boom. In contrast, it has been significantly higher than 5% only on about a dozen occasions, and negative on about half a dozen, since the second half of 2011. Indeed, the prognosis of industrial recovery by the *Economic Survey* seems to be based entirely on the last available data set of November 2017, which came in at 8%. This was however preceded by about a dozen months of successive sub-5% growth.

India's annual merchandise export growth averaged between 20% and 30% in rupee terms between 2002–03 and 2011–12 (except during the global financial meltdown in 2009). This fell to 11.5% in 2012–13 and 16.6% in 2013–14, and slipped into negative territory in 2014–15 (-0.5%) and 2015–16 (-9.5%). The pick up to 7%–8% in 2016–17 and 2017–18 is relatively modest by historical standards, and on top of a diminished base. Despite the modest growth in the last two years, exports comprised a smaller share of GDP in 2017–18 than in 2013–14.

Even the fast-growing services exports, that have played a critical balancing role in India's current account deficit, have shown a declining growth trend, having slipped from double to single digits. If the current account deficit has declined despite poor export performance it is because imports have declined even more sharply, reflecting the decline in oil prices and domestic demand compression. As a result, the external sector, comprising exports and imports of goods and services, has shrunk dramatically from 55.6% of the GDP in 2011–12 to 40.6% in 2016–17.

India's current account deficit crossed 4% of GDP in 2011–12 and 2012–13 when oil prices hovered around \$100 a barrel. It fell to under 2% from 2013–14, and under 1% in 2016–17, with oil prices dipping sharply to around \$30 a barrel. These have however been firming up, having crossed \$60 per barrel. Under these circumstances, a quick revival of exports is critical for both growth and

for keeping the current account deficit within sustainable limits to prevent provoking what the *Economic Survey* describes as a destabilising “sudden stall” in capital inflows.

Bank credit growth has crossed 10% during the last few months, but this was preceded by several years of declining growth. It spiralled down continuously from a high of 14%–18% till the first half of 2014 to settle first in the 10%–12% range (till the first half of 2016), then at a still lower 8%–10% (till the second half of 2016), before bottoming out below 5% during the first half of 2017. Growth in bank credit is dependent both on supply and demand. On the supply side, the *Economic Survey* draws attention to the new Indian Bankruptcy Code for resolving large corporate stressed assets and a “major recapitalization package to strengthen the public sector banks” (2017–18: 1). The amount provided for, however, scratches just the tip of the iceberg of stressed bank assets which stood at over ₹5 lakh crore in 2017 (before the current high profile revelations) according to the Reserve Bank of India, amounting to 9.32% of gross advances, trebling since 2013.

The Role of Private Investment

Even if supply-side problems of bank credit are resolved, there is no guarantee that the demand for it will pick up as this is contingent on revival of private investment. *Economic Survey 2017–18* has a long and interesting chapter on savings and investment. It finds it odd, by the yardstick of cross-country experience, that savings and gross fixed capital formation (GFCF) should have first risen sharply from 29.2% and 26.5% of GDP respectively in 2003 to peak at 38.3% and 35.6% in 2007, and then declined continuously back to 29% and 26.4% in 2017.

Most of the decline in savings is on account of households, and investment on account of private corporates. It does not hold out much hope for an early recovery to the higher levels as the decline derives from balance sheet—bad debt—rather than cyclical issues. This pessimism is borne out by the Centre for Monitoring Indian Economy (CMIE) data

that indicates that new investment proposals in 2017–18 are likely to be at around 60% of the new proposals in 2016–17, the lowest level since 2004–05. This would be the third consecutive year of decline in new investment proposals, with the fall in 2017–18 being sharper than in earlier years.

The survey could have also drawn upon corporate profits data to underscore the balance sheet problem. Having risen consistently from a low of 2% in 2001–02, corporate profits peaked at 7.8% of GDP in 2007–08. They have been declining continuously since, and are expected to come in at 3.9% in 2016–17, the lowest since 2003–04, and significantly lower than the long-term average of around 5% (Pengonda 2015).

In the absence of such revival it is difficult to see how India can return to double-digit growth. Drawing attention to recent research, the *Economic Survey* justifiably argues that in a global economy characterised by a savings glut, it is investment that is more critical than savings. It is not clear from the survey whether this decline has bottomed out. The economy is now growing basically on the strength of consumption, accounting for 95% of GDP growth in 2016–17, and public investment. Fiscal expansion during a downturn is justified on Keynesian grounds, but unless private investment turns around quickly to facilitate exit, the fiscal balance can spin out of control. The stresses are already palpable in slippages from fiscal deficit targets. The government was fortunate that fiscal space was created by the decline in oil prices, which were by and large not passed on to the consumer. This space is now shrinking with oil prices firming up.

If animal spirits do not stoke private investment, the recovery might turn out to be another case of dead cat bouncing. The *Economic Survey* (2017–18: 1) seems to recognise this when it asserts that “above all, India must continue improving the climate for rapid economic growth on the strength of the only two truly sustainable engines—private investment and exports.” Both face major challenges, the former has balance sheet issues, and the latter has to negotiate one of the four ominous horsemen described

in the survey. The survey appears to underestimate domestic demand as India's primary engine of growth, unique amongst the major emerging markets that are mostly dependent on external demand. All three engines need to fire for a return to sustainable high growth.

Way Forward

What then, are the policy actions required to fire the animal spirits of investors? According to the survey:

Over the medium term, three areas of policy focus stand out: Employment: finding good jobs for the young and burgeoning workforce, especially for women. Education: creating an educated and healthy labor force. Agriculture: raising farm productivity while strengthening agricultural resilience. (*Economic Survey 2017–18*, Vol 1, p 1)

Budget 2018–19 has initiatives in most of the above areas. Hard structural reforms however are never easy, especially those required to navigate the four horsemen. Indeed, many of the structural reforms, including those relating to greater economic freedom and the retreat from the licence-quota-permit raj that had pushed the growth potential of the Indian economy from the Hindu rate of growth to one of the highest in the world, seem to have been undone in the past few years.

The sweet spot—a growing economy, a benign external environment, low oil prices, and a strong five-year political mandate for reform—that *Economic Survey 2014–15* spoke of, was not leveraged, and has long dissipated. The political capital was spent on demonetisation—an unwarranted shock out of line with global best practices that appeared to achieve none of its stated objectives—and a watered-down GST, with multiple rates and exclusions, with complex and impractical due diligence that required, and continues to require, myriad corrections.

The survey has also flagged tax administration as a matter of concern. This appears to be becoming more complex and adversarial, with little reassurance regarding a more predictable policy environment, including stability in the direction and rates of the tax system. Peak tax rates on goods and services, including customs duties, have risen rather than declined at a time of falling growth, including the critical services exports, with the centre's gross tax revenue increasing from 10% of GDP in 2014–15 to 11.7% in 2016–17.

While corporate tax rates have been lowered, these need to be benchmarked to the reduced American rates, the new tax normal in an open global economy.

There also seems to be a reversal in the direction of tax reform, which was moving in the direction of reducing reliance on the less progressive and more distorting indirect taxes. Over the last five years, the share of direct taxes in the centre's gross tax revenue declined from 56% in 2013–14 to 51% in 2018–19 budget estimates.

The survey refers to an “educated” labour force, flagging “human capital regression” and “thwarted structural transformation” as two horsemen impeding convergence. In practice, there seems to be little policy focus on scientific temper and productivity shifts in creating and counting jobs. Annual Status of Education studies points to poor foundational skills at the school level, while the flagship, Make in India initiative, is floundering because of the absence of complementary efficiency and productivity enhancing reforms. Dramatic improvements in the Ease of Doing Business rankings, more on account of a change in methodology than change in ground realities, inspire little confidence when these cannot cajole private investors to part with their money, and the chief economist of the World Bank resigns on the issue of methodological changes.

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— From the Trustees of Sameeksha Trust and the Editor of *EPW*

Finally, the role of governance and institutions in economic growth can never be overestimated. Investors need the confidence that the rule of law will maintain social order and ensure economic freedom, including to consume and deploy assets, and that this will be left to individual choice and market forces

and not disrupted by vigilantes. Strong, independent, well-functioning institutions at arms-length from the government inspire investor confidence. There is a growing sense, however, that these are eroding rather than becoming stronger and more independent. *Economic Survey 2017–18* has specifically flagged the

administration of justice, through law courts and independent regulators, as a matter of concern.

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