

Enigmas of the Indian economy | East Asia Forum

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According to the IMF's [World Economic Outlook update](#) of July 2019, India was the fastest-growing major economy in 2017 and 2018 and is estimated to remain so in 2019 and 2020. The headline macroeconomic fundamentals appear benign. The general government fiscal deficit, inflation and current account deficit are within the targeted 6 per cent, 4 per cent and 2 per cent respectively. The rupee is stable.



IMF growth estimates are based on those of India's Central Statistical Organization (CSO). They are contested by reputed [economists](#) as they appear out of sync with several other economic indicators correlated with GDP growth.

Based on these alternative indicators — which seem to reflect growth much like China's [Le Keqiang index](#) — Arvind Subramanian, India's former chief economic advisor, [recently argued](#) that India's growth is 2.5 per cent lower than officially estimated. On the other hand, another noted economist, Arun Kumar, [estimates](#) GDP growth to be just 1 per cent, arguing that neither the CSO, the IMF nor Arvind Subramanian have factored in the recent shrinkage of India's

large informal sector, which accounts for over 90 per cent of employment and almost half of GDP.

The current account deficit conceals a sharp contraction in exports that includes a slowing of India's major engine of growth — information technology-enabled services. Imports have also decreased because of shrinking demand and rising oil prices. International trade as a share of the GDP has [declined](#) from 55 per cent in 2012–13 to 40 per cent in 2019.

The impressive fiscal deficit reduction over the last few years despite declining revenue growth is indicative of a steeper compression of public expenditure at a time of slower economic growth, an overestimation of tax revenues in the budget and a pushing of public expenditure off the balance sheet.

After years of impassioned debate over growth, there is finally consensus that the Indian economy is in crisis. The CSO data shows five consecutive quarters of declining growth. Differences remain over whether [the downturn is cyclical](#) or [structural](#). If the downturn is cyclical, accommodative monetary and fiscal policies should get growth back on track. If the downturn is structural, structural reforms are essential.

The central bank has instigated four policy cuts since February 2019, reducing the benchmark repo rate from 6.5 per cent to 5.4 per cent. More rate cuts are expected soon. Fiscal policy was tightened at the time of the budget presentation in June 2019. The central government's fiscal deficit declined from 5.9 per cent of GDP in 2011–12, to 3.9 per cent in 2015–16 and finally to where it now sits at an estimated 3.3 per cent in 2019–20.

The central bank has ample monetary space to reduce rates further as the policy rate is high when measured by the [metrics of the Taylor Rule](#). Successive rate reductions have done little to reduce the cost and availability of credit due to structural impediments to monetary policy transmission. These include [the lingering banking crisis](#), fiscal pressures and the floor set by regulated small savings rates. The fiscal policy space is constrained by the steep fall in tax revenues, a result of a [poor GST reform](#), that were [not accounted](#) for in the 2019–20 Union Budget and were only partly plugged by the recent windfall received from the central bank.

Countercyclical macroeconomic policies may address the downturn in consumption but the long-term slowing of investment and net exports need structural reform. Other economic indicators show that while there were a few false dawns on account of a declining base, the Indian economy [never fully recovered](#) from the downturn that began around 2011–12. Its growth potential has possibly declined.

Before the Global Financial Crisis (GFC), exports, investment and consumption were increasing. Since then, the export and investment engines have started [stuttering](#). Exports of goods and services have declined from 25 per cent of GDP in 2013–14 to less than 20 per cent in 2019. Gross domestic capital formation declined from 36 per cent in 2007–08 to below 30 per cent in 2015–16. It has stagnated ever since.

This left the economy running on consumption. Consumption has always been a higher share of India's national income, insulating it against global downturns. Its [share](#) of GDP increased from under 66 per cent in 2010–11 to over 70 per cent by 2016–17. But this increase could not compensate for the slowdown in investment and exports.

Unless other engines of growth also fire, macroeconomic policies will find it difficult to exit. The aftermath of the GFC in western economies has shown that protracted use of monetary and fiscal policies can create new imbalances of their own.

A market economy is driven by private investment. The revival of the investment cycle is depressed due to policy unpredictability, knee-jerk interventions, policy ambivalence and fears over institutional integrity. The new tax proposals in the budget were rolled back within two months with little clarity on whether they were temporary remissions or structural reforms part of a long-term roadmap. This was followed by a poorly thought-through bank merger.

It would need more than a laundry list of measures to return the economy to a high growth track. The government needs to articulate whether it is changing its economic policy roadmap to a piecemeal policy approach of policy shocks like demonetisation and tax reform reversals. The perception that the [independence of the central bank](#) is shrinking, evident in the sharp increase in the Reserve Bank of India's surplus transfer to the government this year, is damaging.

In a market economy, a government must reassure markets that it will handle the economy with a light touch. In addition, the institutions of governance must retain their independence to keep markets open and competitive, enforce the rule of law uniformly and maintain social order and harmony.

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