Growth Optimism Unwarranted

Although India has bucked the global trend by recording a GDP growth of 6.7 per cent in 2008-09, the spurt in growth had a lot to do with non-sustainable factors which cannot form a basis for future growth. Hence, the talk of green shoots is misplaced given the realities on the ground, says **Kunal Kumar Kundu**

The recently presented budget seems to have been formulated more on hope and intent rather than on ground realities. This is best exemplified by the hope that our GDP would grow by 7.1 per cent during 2009-10. In reality, however, we would be lucky to even touch 6 per cent. Here's why.

As mentioned, the expected growth is more a statement of hope and this hope was kindled by the fact that the Indian economy proved to be quite resilient and has seemingly bucked the global trend by growing at 6.7 per cent in 2008-09. While this is lower than what we recorded in the past few years, it was still higher than what the market expected. That surely was a positive surprise. But a closer look reveals that the spurt in growth had a lot to do with non-sustainable factors, and cannot form a basis for future growth.

An analysis of the number reveals that robust agricultural growth and government expenditure carried the day for the economy in the last quarter (Q4). Agriculture, which showed a negative growth in Q3 (-0.8 per cent) recovered in Q4 to register a growth of 2.7 per cent. On the expenditure side, it is the government expenditure that stood out. During Q4, government's final consumption expenditure grew by about 21.5 per cent YoY, leading to an increase of 20.25 per cent between 2007-08 and 2008-09, an indication of the stimulus package. The important question is, would both these catalysts continue to deliver in the current year. Quite unlikely.

A great part of the stimulus was arrears payout to the civil servants as part of the 6th Pay Commission report. Without this stimulus (which is not going to be a permanent fixture), the growth would have been quite muted. In fact, if one looks at the data for the second half of the financial year when the Pay Commission arrears were paid out, about 31 per cent of the incremental growth (YoY) was accounted for by the arrears payment alone.

Gross Capital Formation in agriculture (@ 1999-2000 prices (Rs/Crore)

Period	Share of agriculture in total GCF (per cent)
1999-00	8.6
2000-01	8.0
2001-02	10.2
2002-03	8.4
2003-04	6.7
2004-05	6.2
2005-06	5.8
2006-07	5.8
2006-07	5.7

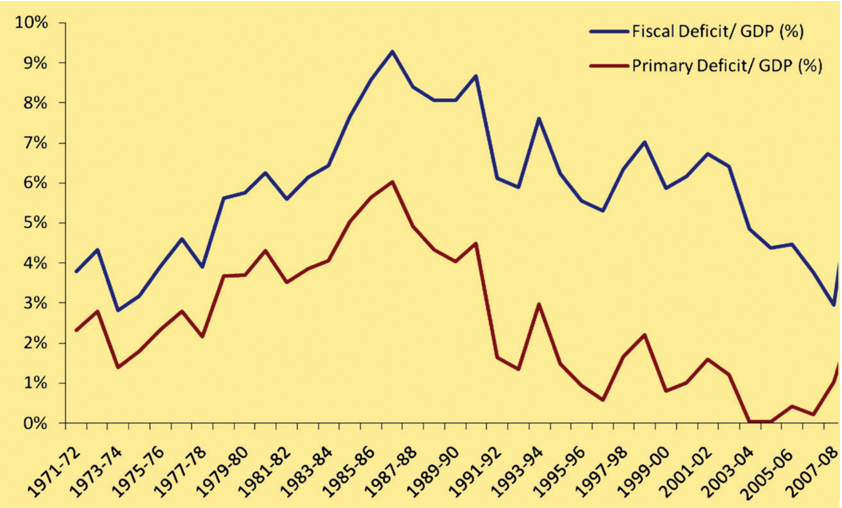
Source: Economic Survey (2007-08, 2008-09)

Even the agricultural sector, which recovered during the 4th quarter to record a strong growth, is unlikely to provide adequate stimulus going forward. A sector so highly dependent on monsoon will be at the receiving end of deficient rainfall this year. While some parts of the country are reeling from drought-like situation, there are others which are facing flood. There is, therefore, every likelihood that agriculture cannot prop up the GDP numbers to the extent desired.

In this regard, however, monsoon is only one part of the equation. Underinvestment continues to plague this sector. As per the 11th Five Year Plan (FYP) document, India needs to invest about Rs 6 lakh crore in the agricultural sector during the 11th FYP period if it is to achieve a growth rate of 4.1 per cent. However, in the first year itself, there has been a shortfall in investment by about a third, what with total investment at about Rs 79,300 crore only.

This is not surprising. Indeed, the story of Indian agriculture is a story of ill-conceived and, quite often, inappropriate policies. India's response to high incidence of malnutrition and undernourishment has been, paradoxically, one of falling investment.

So, will industry provide the much-needed succour? Quite unlikely again, although some analysts have started seeing green shoots all around. Revival in IIP after months of decline, improving corporate profits and hence tax collection is seemingly spreading a lot of cheer. As supposed signs of recovery, IIP in May rose by 2.7 per cent and that in April by 1.2 per cent after having experienced bouts of decline in the previous months. As I mentioned in my blog (http://kunalsthoughts.weebly.com/blog.html), the index which touched 281.9 is still lower in values from the December, January and March numbers. Also, the growth for Apr-May'09 at 1.95 per cent is way below 5.3 per cent recorded during Apr-May'08. A good part of this growth is attributable to election related spending as well as temporary demand generated by huge amount of arrears payout received by civil servants following the 6th Pay Commission report. Not surprisingly, post the arrears payout in February, while there has been a sharp jump in consumer durables production during Apr-May'09, the overall production of consumer goods was actually negative at -1.2 per cent during the same period. Even the production of capital goods was negative during the period – which indicates a lack of business confidence in growth prospects, espe-



(Source: RBI Handbook of Statistics and my calculation)

cially faltering domestic demand.

It is very important to note that private consumption has taken a lot of beating as is reflected in the Q4'08-09 GDP number. The private final consumption expenditure (PFCE) grew by a meagre 2.7 per cent YoY in Q4, thereby dragging down the annual increase to only 2.87 per cent. So far, there is no sign that domestic demand has really picked up on a sustainable basis. Increasing corporate tax collection is not an indication of economic recovery at this point in time. This is because, while a number of corporates have been able to record improved profit margins, it has lot to do with aggressive belt-tightening measures in response to the difficult business environment rather than real increase in revenue. In fact, overall revenue grew ever so slowly. This indicates that there has not been much revival in domestic demand as is claimed by the proponents of green shoots.

Now, we need to understand India's deficit scenario. The following equation is useful for better understanding: Fiscal deficit = primary deficit + net interest payment

In the chart given above, the widening gap between the two, therefore, reflects the cost of India's fiscal profligacy, i.e., interest payment. In the last financial year, net interest payment constituted 59.02 per cent of India's fiscal deficit. For the current year, it is budgeted to be 56.25 per cent. This means that more than 50 per cent of India's borrowing need is required to meet only the interest obligations. While this in itself is not a comforting signal, does that necessarily mean that the remaining amount that is borrowed is used for productive purpose? Not quite so. To understand this, it is important to understand the revenue deficit trend. Last year, the revenue deficit was close to 74 per cent of the fiscal deficit. For the current year, it is budgeted at nearly 71 per cent. This implies that more than 70 per cent of government's borrowing would be utilized to meet the government's housekeeping expenses, leaving the rest for investment. As a result, when the economy was growing at a very fast pace, wasteful expenditure kept on increasing. For example, in a recent report, the Planning Commission found out that for every one rupee that reaches a BPL (Below Poverty Line) household, the government spends Rs 3.35 on the logistics, resulting in a huge wastage. As a result, after having met with all expenditures, there's hardly much left with the government to invest gainfully.

That apart, virtually all the focus of stimulus package (during the current budget) was aimed at such socially relevant projects. While increase in social sector investment is praiseworthy, the fact is the growth multiplier of such investments is much less than that of investments in various areas of physical infrastructure.

Not surprisingly, while the recent Economic Survey stressed the need to spend about 9 per cent of GDP on infrastructure during the 11th Five Year Plan (2007-2012), the envisaged investment in infrastructure during the current financial year is still less than 5 per cent of expected GDP. And even this might not materialize if there is further strain on resources. This, in fact, is quite a possibility since the budget makes no provision for the proposed Food Security Act and assumes that current global prices of oil and fertilizers will not rise. Moreover, it optimistically projects a 15 per cent rise in corporate tax receipts, even as income tax revenue declines 9 per cent.

Clearly, there is very limited capability of the government to provide the right kind of economic stimulus. In contrast, China, which recorded a GDP growth of 7.9 per cent in Q2 of 2009 was able to do so because of the effect of huge stimulus package (about USD 579 billion). The aim of the package was to boost domestic consumption through higher spending on construction of highways and other public works.

Hence, the domestic demand is unlikely to ratchet up the GDP growth number to the desired extent. This leaves external demand to come to the rescue. And India's export performance has been anaemic at best ever since October last. And, during the last three months, India's exports in dollar terms were down by more than 30 per cent on an average. While in the month of May, the decline was marginally lower at 29 per cent as compared to over 33 per cent in the previous two months, the extent of decline is still very high for comfort. Going forward, it is likely to remain soft, given the global scenario. While there are some signals that the US economy might bottom out towards the end of 2009, a closer look at the data does not give confidence that there will be a 'U'-shaped recovery. The recovery is likely to be very slow and one cannot also ignore the possibility of another dip going forward. And the less said about Europe, the better.

On the whole, therefore, there would be enough constraints that would hold back the economy this year and even years to come.

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