Back to Normal Growth?

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There has been a great deal of excitement among policy-makers and analysts during the past couple of days about the 7.9% growth that the Indian economy has recorded during the July-September quarter. The growth rate has exceeded even the official forecasts that are usually quite optimistic. Some have sought to explain why second quarter (Q2) growth has been so high while others have opined that this growth will not be sustained during the second half of the year. Yet others have asserted that India is now back to its normal growth path of 8% plus.

Sound judgment on any of these issues has to be based on a clear understanding of the main sources of high Q2 growth and an assessment of the risks of sustainability associated with those sources. In this context it is useful to recognize a fundamental distinction between agriculture on the one hand and industry and services on the other. In agriculture variations in production are primarily attributable to supply side conditions, including the extent and timing of rainfall. Levels of supply and demand are then balanced through price changes. Economists call this market clearance through price adjustments, though this mechanism is somewhat distorted in India by government assured support prices for food grains and a few other commodities. In industry and services where producers are able to control levels of production much better compared to agriculture, variations in production are mainly explained by conditions on the demand side: market clearance through quantity adjustments. Prices in these sectors are less adjustable and more rigidly linked to costs of production.

Turning now to the composition of high Q2 growth, it turns out that it is almost entirely accounted for by growth in industry and services, led by social and personal services at 12.7 %, mining and quarrying at 9.5 % and manufacturing at 9.2 %. In contrast agriculture has grown by less than 1% compared to the corresponding period last year. The earlier discussion of demand led variations in levels of production in industry and services would then suggest that high Q2 growth is mainly attributable to buoyant demand conditions, an assessment that is reinforced by a sharp fall of over 45% in inventories.

Are these buoyant demand conditions likely to be sustained? That depends on the outlook for the main components of external and domestic demand, i.e., net exports, private consumption expenditure, investment and government consumption expenditure. External demand or net exports (exports net of imports) is the most risky component of demand. This was the main channel through which recessionary impulses were transmitted from the developed countries to the Indian economy during the past year. Though exports have continued to decline, the value of imports has fallen faster, partly because of an appreciating rupee. This has helped increase the net demand for Indian products abroad.

However this could change. Though recession has bottomed out in most of the developed countries, it is not clear at this moment what will be the final effect of the Dubai debt default a few days ago. Earlier analysts debated whether recovery in the developed countries would follow a sharp V shaped path or a more gradual U shaped path, the majority view opting for the latter. Recently, a view has emerged that the recovery will be aborted by a second global economic shock. This implies that the developed countries will follow a prolonged W shaped recovery path, with a second slump waiting to happen. Is the Dubai default that second economic shock? Hopefully not, but it could be. After all when defaults on housing mortgages started to build up in the US from early 2007, nobody had expected that it would snowball into a full fledged global economic crisis by Octoer 2008. We have not yet seen the final effects of Dubai.

Among the domestic sources of demand the two largest are private consumption and investment, which together account for about 90 % of total demand. Their combined growth is a little over 6%. Whether or not this will be sustained for the rest of the year will depend on several factors, specially what happens to inflation, interest rates and the fiscal stimulus. Finally, there is government consumption expenditure that accounts for only around 10% of aggregate demand but has been the fastest growing component. It grew by nearly 27 % compared to the same period last year, when the government was still attempting to compress expenditure. This is the most buoyant driver of high growth in Q2 and it is of course a direct consequence of the fiscal stimulus being pursued by the government.

Thus, apart from the external risks, the possibility of sustaining high growth will depend very much on inflation and the fiscal and monetary policies that the authorities pursue. Here the authorities are in a dilemma. Food prices are now inflating at over 15%. This will put upward pressure on wages and wage costs in industry and services, leading to more generalized inflation. This will in turn lead to a reduction in purchasing power, and reduced growth via reduced private consumption demand. To reign in inflation the RBI has signaled moves towards a tighter monetary policy and interest rates are likely to rise later in the year. Also, while the fiscal stimulus has not been withdrawn, the Government is now working towards fiscal consolidation in the next budget. These policies may help curb inflation, which is also good for growth, but they will have a more direct negative impact on growth.

What should the government do? First, there are conflicting policy goals of sustaining growth and curbing inflation but also multiple policy instruments. Monetary policy conducted by the RBI should be assigned to containing inflation, which is a central bank's principal mandate. Fiscal policy can then continue to focus on promoting growth. If the government is eventually forced to choose between growth and inflation then hopefully it will opt for lower inflation at the cost of slightly lower growth. Rising inflation will soon become a political liability. It is no longer just the blue collar and white collar workers who are complaining about the rising price of food, but even the elite.

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