Opinion | How India’s economy smoothly navigated troubled waters

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Given its integration with the world economy, India cannot continue to grow rapidly as global growth declines

The economic outlook is gloomy. However, let me start on a positive note. The advance estimates of national income indicate that real gross domestic product (GDP) will grow at 7.2% in FY 2018, up from 6.7% last year. The advance estimates, based on data for the first six months and up to November for some indicators, are a fair assessment of the likely outcome. The earlier projections of the Reserve Bank of India (RBI), the International Monetary Fund (IMF) and the World Bank are also all higher than the advance estimates. Hence, barring any major shock in the next 10 weeks, it is quite likely that the year will end with at least 7% growth. This robust growth is also fairly diversified with more than 8% growth in manufacturing and 9% growth or more in electricity and other utilities, construction, and public services.

It is particularly encouraging that the growth upturn is being led by the recovery of investment instead of debt-financed consumption as in the recent past. After stagnating for several years, quarterly growth of gross fixed capital formation (GFCF) has been recovering since the second quarter of FY 2017. It is now estimated to grow by 12.2% in real terms in FY 2018 compared to 7.6% in FY 2017. The investment rate, which had declined to 31%, is now estimated to be back up to 33%.

The other good news is the low rate of inflation. The consumer price index (CPI) inflation rate is now down to only 2.2% and the wholesale price index (WPI) inflation rate is 3.8%. However, the decline in inflation is mainly on account of the decline in food and fuel prices. Fuel prices are unlikely to harden any time soon, unless events in West Asia deliver a political shock. This has been a great boon for oil importing countries such as India.

However, whether the decline in food prices, which implies a shift in the terms of trade against agriculture, is an unmixed blessing in the present context of widespread distress among farmers is a question to be pondered over. Also, core inflation (excluding food and fuel prices) is still close to 6%. This presents a dilemma for monetary policy. RBI’s mandate is to contain the CPI inflation rate at around 4%, but can it ignore the stickiness of core inflation around 6%, especially when central and state government spending is likely to pump-prime demand in the run-up to general elections?

That was the good news, admittedly somewhat mixed. It has to be assessed along with news that is not so good, on both the domestic and the external fronts. I have mentioned the expected surge in pre-election public spending. Combined with a significant shortfall in tax revenues, especially goods and services tax (GST) revenues, this will lead to several fiscal deficit targets of the central and state governments being breached. On the other hand, the past record of political business cycles suggests that there could be a sharp decline in public spending in the post-election period. These swings in public spending can be destabilizing and adversely affect growth in FY 2019.

Further, implementation of the 2016 Insolvency and Bankruptcy Code and progress on resolutions under the National Company Law Tribunal are important reforms. Nevertheless, there is still a long way to go in tackling the problem of stressed assets and high levels of non-performing assets in public sector banks. This is a major deterrent to growth. There is also a return to discretionary interventions, demonstrated among other things by the arbitrary raising of tariffs in the last budget. These too will adversely impact growth in FY 2019.

Far more worrying than these domestic issues, in my view, is a very challenging external environment. 2018 was the year of great decline. Everything declined: inflation, commodity prices, asset prices, growth. While the decline in inflation is welcome, the decline in growth has now raised fears of deflation in advanced economies. The IMF Data Mapper, which maps growth throughout the world, looks pretty scary. More than half the globe is a dark region shrouded in grey (below 3% growth) or black (negative growth). Soothing shades of green, representing robust growth, are seen only in Asia and a few countries in Africa. Emerging markets and developing countries in Asia grew at 6.5% while sub-Saharan Africa grew at 3.1%. Among major economies, growth declined in 2018 and is expected to decline further in 2019 in the US, European Union, Japan and China. Together, they account for almost two-thirds of the world economy.

Underlying these gloomy numbers is the emergence of multiple risks: the trade war between Trump-led US and China; tensions between US and its European allies, Canada and Mexico; confrontation in West Asia between the Trump-led coalition of the US, Saudi Arabia, Egypt, and the tacit alliance of Iran, Russia, Turkey, and Syria. The potential spike in oil prices if that confrontation escalates and financial outflows from emerging markets in response to political uncertainties and rising US interest rates are the other major risks.

India stands out for sailing smoothly through these troubled waters so far. It remains the fastest growing major economy in the world. However, being well integrated with the world economy, India cannot continue to grow rapidly as global growth declines. The trade deficit, up from 1.7% of GDP in 2016-17 to 3.0% in 2017-18, is projected to rise further to 3.5% in 2018-19, thereby completely offsetting the expansionary impact of the fiscal deficit. The net reduction of nearly $30 billion in foreign exchange reserves since 1 April 2018 is also a consequence of the gloomy global economic environment.

These adverse external factors, combined with the domestic challenges mentioned earlier, will pull growth down to less than 7% in FY 2019. It could decline further in the event of a major negative shock such as a failed monsoon or a spike in global geopolitical tensions.

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