Deceleration, Demonetization and GST: Growth Prospects and Policy Solutions

By

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Abstract

This paper reviews the growth performance of the Indian economy since 2011-12 using the new GDP series with base 2011-12, and analysis the reasons for declining growth, with a view to identifying policies that will help restore growth to the 8% ranges.

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Introduction

Many public policy economists have written in newspapers and said on TV that economic growth has collapsed and the Government needs to do something dramatic like a big fiscal boost to the economy. In my view the debate is heavily politicized with too many commentators looking selectively at the data which supports their political predictions. Many are genuinely puzzled by the fact that their forecasts of recovery in 2017-18 Q1 didn't materialize. Rather than starting from scratch and re-examining their assumptions in the light of new data, they seem to be throwing up their hands in despair.

Some economists have argued that the 5 (4) quarter deceleration in GDP(GVA) growth rate from a peak of 9%(8.7%) in 2015-16 Q4 to 5.7%(5.6%) in 2016-17 Q4, is a negative structural change in the economy and is unprecedented since 2007-8 to 2008-09. In fact GDPMP had a four quarter deceleration from 2009-10 Q4 to 2010-11 Q1 and GDPFC a 5 quarter deceleration from 2010-11 Q4 to 2012-13 Q1 followed by four quarters of stagnation. Two contrasts and one similarity are noteworthy: One, the economy faced an unprecedented external shock in October 2008, which along with the policy response determined the outcome. The unprecedented nature of this shock is still poorly understood: GDP growth fell from 9.7% to 3% despite a large fiscal and monetary stimulus. In the second episode mining, including associated legal-political uncertainties played a role. Second, the Indian economy was characterized by high inflation from second half of CY 2009 to 2011, in contrast to deflation in CY 2015 and 2016. In all three episodes an increase in net imports (imports-exports) seems to have played a role in deceleration/stagnation.

Many economists, who are assuming that it is a negative structural change, with no normal and/or cyclical self correcting developments in sight, also argue for a large immediate fiscal stimulus as the only available method of reversing the situation (as perceived by them). The assumption that a higher fiscal deficit will translate into sustained higher growth, no matter what the nature of the actions taken is not supported by historical evidence. The effect of higher expenditure on growth will depend on the type and nature of these expenditures. The effect of lower tax rates on growth, depends on whether (or not) they are part of an effort to reduce tax evasion, corruption and uncertainty. The nature of financing, whether through sale of unproductive government assets or through market borrowing will also affect the fiscal multiplier. This article disagrees with both the premise of sustained downtrend and the proposed fiscal solution.

We start by looking at the medium term trends from 2011-12 (the start of the new GDP series), both on the demand side (GDP) and the supply side (GVA). This provides the backdrop to an examination of more recent trends over the last 6 quarters. We then analyze the potential causes for the recent downtrend in economic growth. Based on these recent trends we estimate the loss of GDP/GVA growth as a result of demonetization. Finally we examine potential policy actions that government can take to expedite recovery.

Six Year Growth Perspective

The medium term growth since the start of the new GDP series is characterized by an aborted growth recovery (figure 1). A rise in GDP(GVA) trend growth from around 5% (5.2%) in 2012-13 Q1 to 7% (6.5%) in 2015-16 Q2 to 6.6%(6.5%) in 2017-16 Q1. During this period private consumption growth has been on a gradually accelerating trend, and with second normal monsoon eliminating the lingering effects of two consecutive droughts, pessimism about the future on this demand driver is unjustified.

Private fixed investment (GFCF), though highly volatile, has been on a decelerating trend after showing some signs of recovery. Disaggregated data (available only till 2015-16) shows that much of this decline is due to a slowdown in growth of Unincorporated sector's investment in dwellings, other buildings and structures. This has declined by an average -1.4% during 2012-3 to 2015-6, while private & public non-financial sector investment have grown by 8.2% and 5.5% (in const prices). Thus the formers share in total fixed investment has declined by about 7% points to 30.6% in 2015-16 (in current prices).

Growth of Inventory-Stocks (CIS) a component of Investment, has also decelerated sharply in 2016-17 after two years of dramatic growth (in real, constant price terms). This deceleration is partly due to (1) measurement problems associated with the inflation-deflation-reflation cycle (figure 8) (2) Price expectations and the expected value of stocks, and (3) Uncertainty about GST rules for offsetting inventory accumulated prior to start of GST. Most of this is now over and we are likely to see a return to normal stock growth after a trough of 1.2% real growth in Q1 of 2017-18.

The U shaped trend in growth of Exports and Imports is noteworthy, with a parallel deceleration followed by a much sharper acceleration in Imports over exports in the last two quarters (figure 2). Thus net imports (imports-exports) have ballooned in 2017 H1, driven mostly by a discontinuous jump in imports.

On the production side, manufacturing has gone through a complete growth cycle during this period, with a growth trough in first half of 2013-14, a growth peak in first half of 2015-16 & deceleration since then (figure 3). Construction, after a very volatile start in 2012-13 & 2013-14 has settled at a low level growth of about 3% (fig 3).

The Union Government took actions to reduce corruption in Delhi and "black money", such as the judicially supervised SIT on black money, actions on foreign holdings (Swiss banks, Panama papers), the Benami Holdings Act, RERA and Demonetization. However, State policy and controls on land and real estate remain unreformed, as does the hold of corrupt officials at the State, municipal and District level. This contradiction between increased scrutiny of unincorporated/household investors and unchanged corrupt practices of officials & politicians at the State-municipal level, has resulted in sharp deflationary pressures, dampened real estate and construction activity and drastically reduced household investment in dwellings and other structures.

Figure 1: Growth Rate of GDP, Private Consumption and Fixed Investment

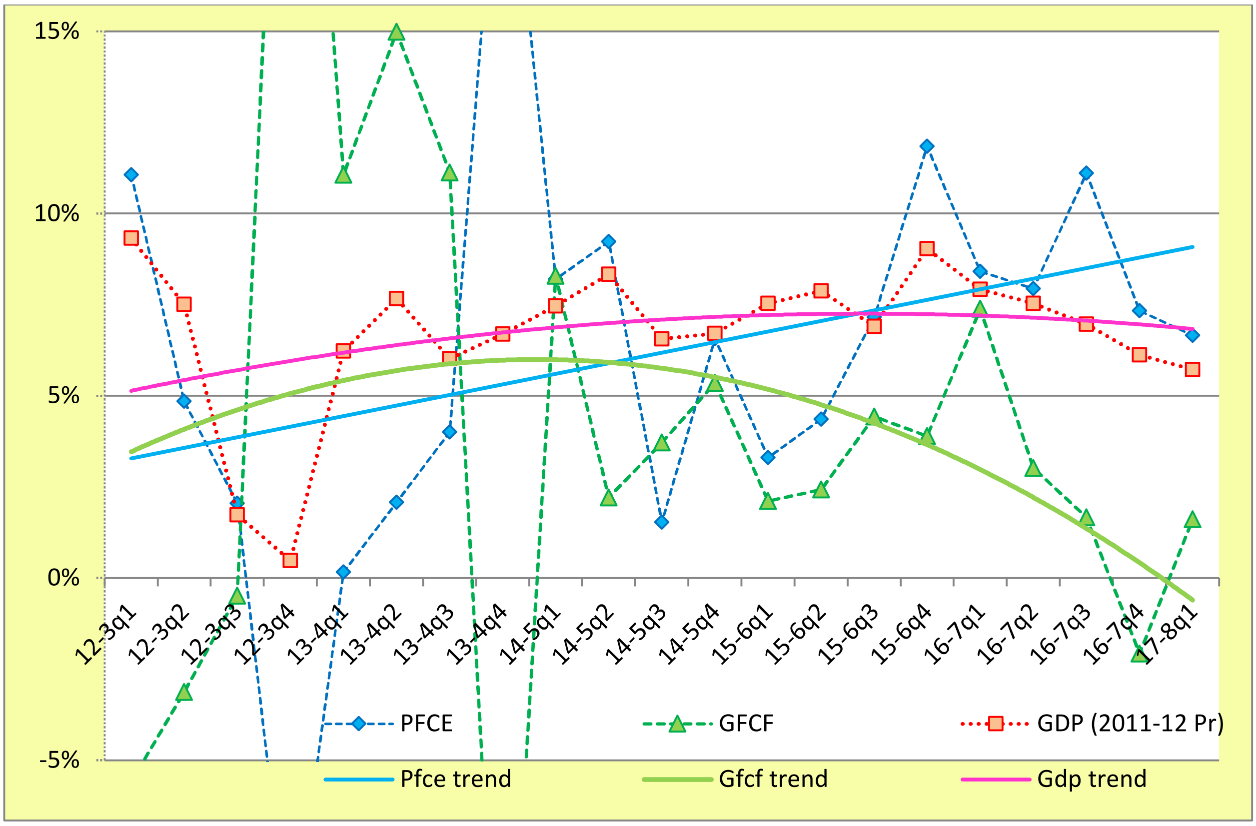
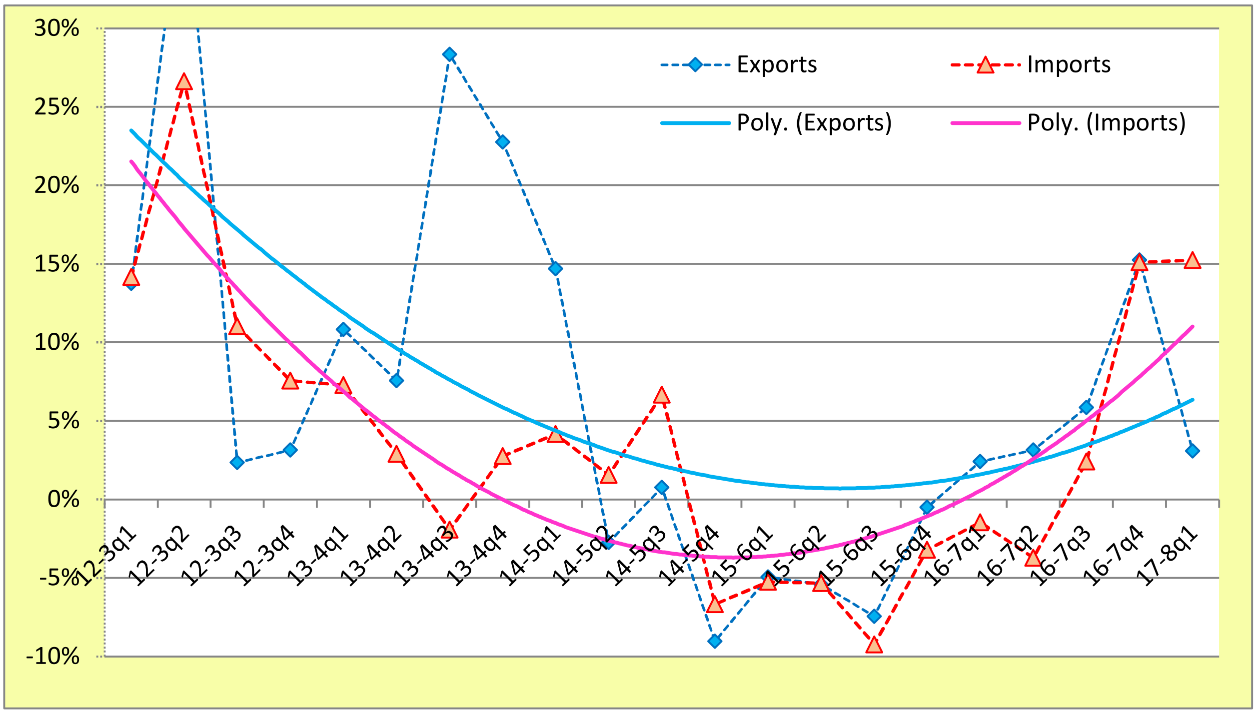


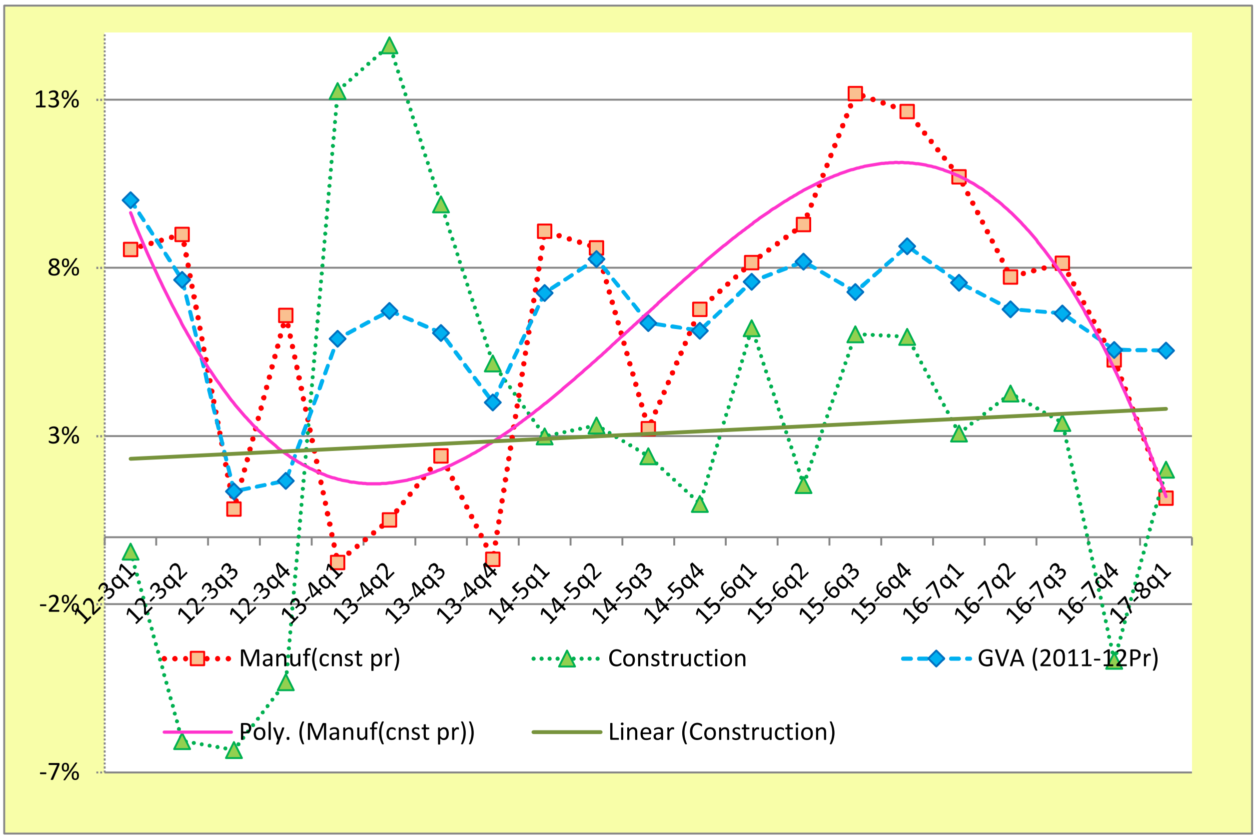
Figure 2: Growth Trend in Exports an Imports



Besides these changes in real economy, one noteworthy financial change relates to the excess of savings over Gross fixed investment by different economic agents. For the first time in 2015-16 Savings (retained earnings) of private non-financial Corporations exceeded their fixed investment (after rising sharply in 2014-15). Data from company investments in mutual funds and stock market boom suggest that this has probably continued in 2016-17.

There are two plausible reasons. One is that corporate tax changes have tilted the incentive from payment of dividends towards retained earnings. Second, is that negative policy changes and regulatory mistakes have reduced Ease of Doing Business and increased uncertainty in select sectors like Pharma, Medical instruments, Seeds, Telecom, Natural gas and Corporate sector with respect to limited liability. However caution is in order, because most of these specific examples are from 2016-17.

Figure 3: Growth trends in manufacturing and Construction



Demonetization

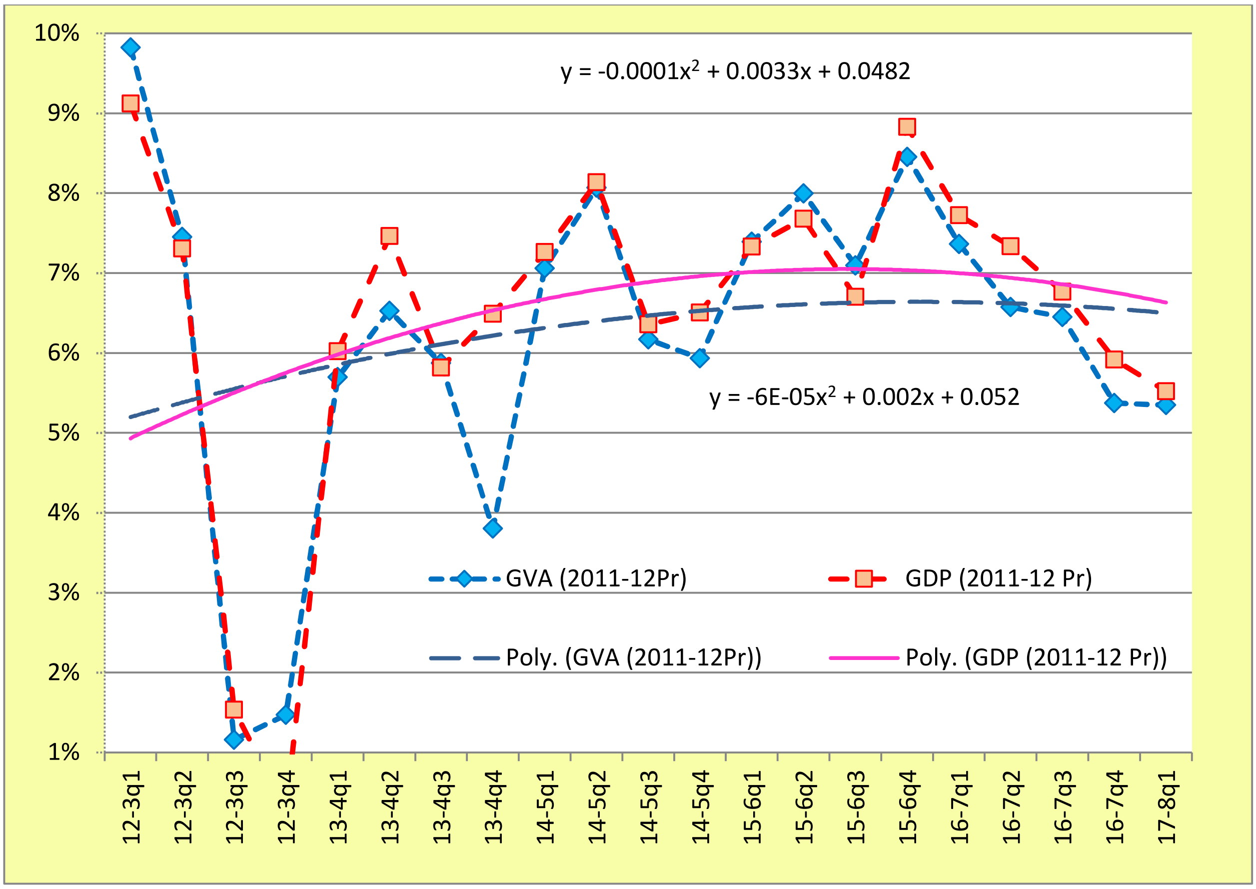
Analysis of more recent trends have depended heavily on data revisions; The advance and revised estimates for the year 2016-17 gave some indication of the effects of demonetization on GDP growth. However, there were doubts and disagreement between analysts about whether the negative effects would be limited to Q4 of 2016-17. With the CSO releasing data on Q1 of 2017-18, we are in a better position to provide a quantitative impact of demonetization on GDP, as the effects of demonetization can be separated from the earlier deceleration of growth from its quarterly peak in mid 2015-16. We are also in a position to take stock of earlier forecasts of GDP for FY 2017-18.

In the article titled "Black Money and Demonetization," we had analyzed the economic effects of demonetization.[1] Given the paucity of historical data on demonetizations across the world, it was virtually impossible to give quantitative estimates of the potential reduction in GDP and had a large dollop of guess work(at that time). However, the analytical conclusions have played out exactly as laid out in that note. It is now also possible to make better quantitative estimates, with the GDP data now available; We estimate that Demonetization reduced Growth of GDP and GVA by ~1.2% point(+/- 0.1%) in *first half of 2017* or by ~0.6% point in 12 post-Demonetization months, assuming the effect is negligible in remaining four months to November 7, 2017. This estimate is at the mid-point of the forecast range of -0.2% to -1% on 12 month basis[2].

The methodology (though far from perfect) accounts for/adjusts for the decelerating trend in quarterly GDP growth since the middle of 2015-16 (figure 4). One side effect of the disruption of supply chains by de-monetization, was to divert orders for manufactured goods from domestic to foreign suppliers. This resulted in an unprecedented jump in imports in the last quarter of 2016-17, with spillover effects into 2017-18 Q1 (figure 3). Consequently, Import growth reduced domestic demand by 1/2 the total increase in GDP during the 4 quarters ending June 2017. The effect of this temporary diversion have likely been played out, so import growth will most likely return to trend.

To get an idea of the sectors most affected by demonetization we compare average growth in the two full post-Demo quarters(2017 H1) with the two previous quarters(2016 H2) when the effect of demonetization on GDP/GVA was minimal; On the production/supply side, Manufacturing and Construction growth declined by 4.7% points each and Agriculture by 1.7%. Wage data suggests the negative effect on agriculture was concentrated in harvesting/picking of commercial & horticulture crops and to a small extent in animal husbandry.[3] On the demand side Import growth was higher by 13.5% points, indicating a huge leakage of demand from domestic to external suppliers. Stocks and GFCF growth declined by 3.8% and 2.6% points respectively, while private consumption growth declined by 2.5% points. If the demand for cash has been fully supplied, all these should revert to near trend growth in 2017-18 Q2.

Figure 4: Trend Growth of GVA and GDP



Deceleration in GDP growth: 2015-2016

GDP growth decelerated from 7.9% in July-Sept 2015 (2015-16Q2) to 5.7% in April-June 2017 (2017-18Q1), while GVA decelerated from 8.2% to 5.6% over same period. Our analysis suggests that GDP growth deceleration since mid-2015-16 is due to the following factors:

(a) *Monetary policy* has not only been tight for last two years, but has tightened over last 18 months because of sharply falling inflation. The real repo rate has been on an uptrend from the beginning of 2014, rising from a neutral 0.3% in January 2014 to 6.3% in august 2017 (figure 5). Real non-food credit (manufacturing) decelerated from 6.4%(12.1%) in 2011-2 to 3% (3,8%) in 2012-14, and has averaged -1.8% (-3.4%) during 2014-17. The effect of real rates on non-food credit is demonstrated in figure 6. The direct negative effect of rising real interest rates has been strongest on household investment in housing and structures, construction sector and manufacturing,[4]

Another consequence of high real rates relative to global rates, is excessive capital inflows into debt (and carry trade, which gives free money to foreigners). This results in appreciation of the real effective exchange rate of the Rupee (REER 36), which has appreciated from 104.7 to ~120 over the same period. Since February 2015 it has however moved progressively above the gradually appreciating trend line & appreciated by 6.6% till July 2017 (figure 7). This in turn resulted in loss of competitiveness & worsening of net exports of goods (Exports-Imports: X-M), which are almost 62% of its absolute value in Q2 2015-16 and 48% of its absolute value in Q1 2015-16.[5]

(b) *Public Sector banks(PSB) NPAs* were incurred largely in 2009-13, after the Global Financial Crisis(GFC) in 2008, partly because of the unjustified euphoria generated by quick recovery in 2009 due to inappropriate fiscal-monetary policies. The recovery led to abandoning of fiscal sobriety in 2010 and lending pressure by government on Public sector banks. However, the increasing NPAs were mostly hidden or in speculative domain. Tighter regulations on NPAs since 2014 and their disclosure to public, forced Banks, companies and capital markets to see & evaluate the risks more carefully and clearly, worsening Credit flows from PSBs. This combined with a rise in real interest rates (figure 5 & 6)) has added a further blow to private fixed investment particularly household investment) which has consequently decelerated for four quarters of 2016-17 compared to the six quarter deceleration of GVA (figure 1).

Figure 5: Real loan and Repo rates

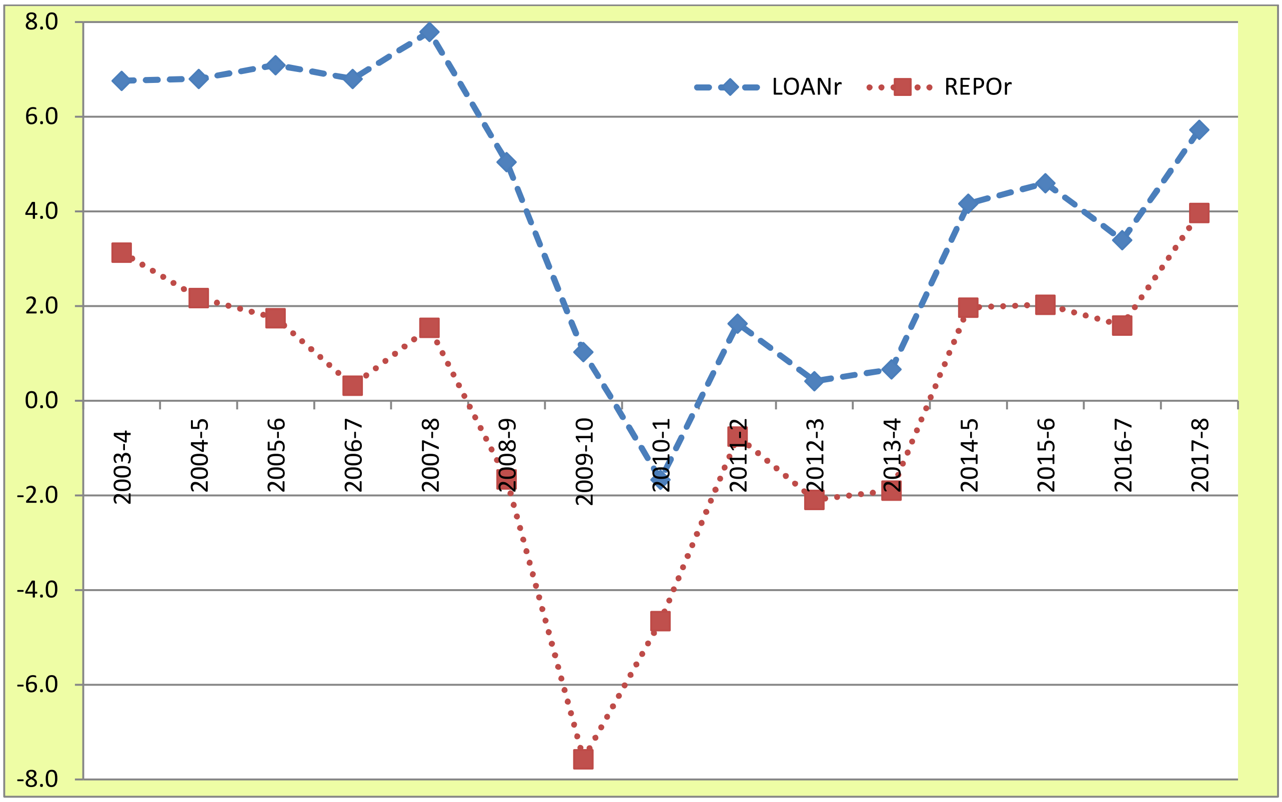


Figure 6: Co-relation between Real Credit growth and Real Repo Rate since 2008-9

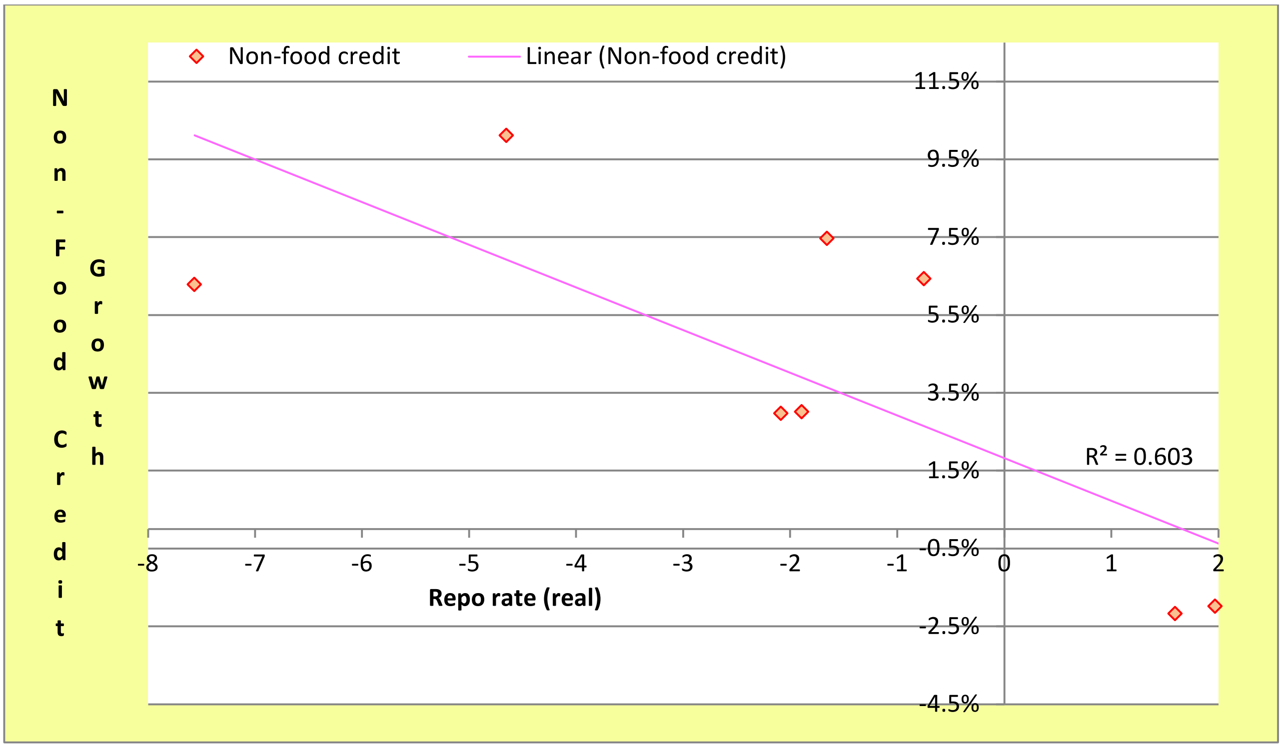


Figure 7: Real Effective Exchange Rate(REER ; 36 country)

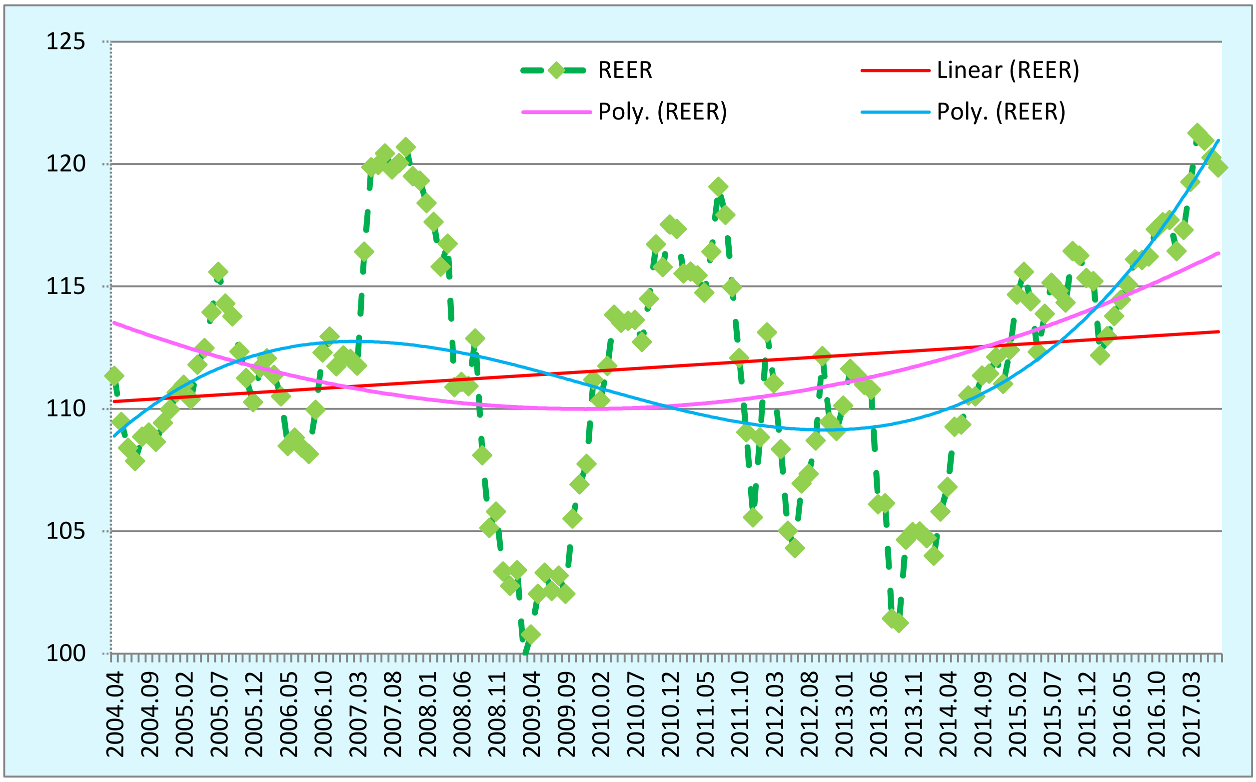
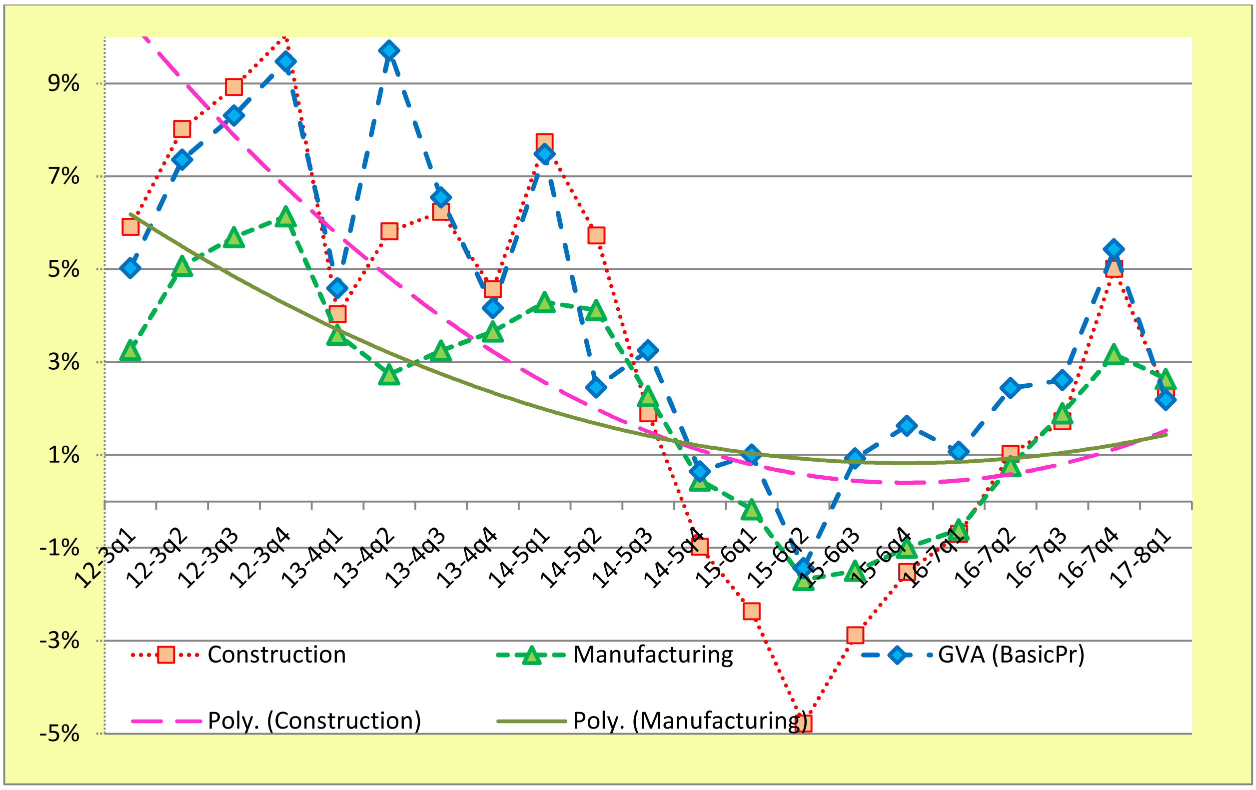


Figure 8: Effect of Deflation and Reflation



Reforms for Growth

With uncertainties and risks from introduction of GST still hanging over the economy, the key question at this point is what specific policy changes can help revive growth: In the light of our analysis of the reasons for GDP growth slowdown, the following reforms, in order of feasibility and impact, should be accelerated by government:

Fiscal & Financial

The best fiscal stimulus is to increase tax simplification and capital expenditures and sell off loss making PSUs and PSBs, and not worry if these raise fiscal deficits in the short term while putting the fisc in a more sustainable position. Government must refocus on subsidy reform and put the savings from reduction in corruption and improvement in administrative efficiency into public goods infrastructure investment. A much bolder reform the integration of cash transfers with income taxes, a Negative Income Tax (NIT) or Net Income transfers will have to wait for budget.[6] With rising domestic inflows driving the stock market boom, time is most apposite for *PSB disinvestment and strategic sale of loss making PSUs*. These proceeds must also be used to accelerate public investment in infrastructure. The 2017-18 budget had projected a 20% increase in capital expenditure. It is essential ensure and if possible raise this growth target, both to raise total investment in economy, as well as to crowd in private investment.

The focus of the GST council on minimizing disruption for consumers and revenue neutrality (by product category) has made the GST system too complex. Bureaucratic advisors have added to this through additional accounting, reporting & refund rules on services that function across State borders, on exporters and on Intra-State transport of goods(e-way bill). GST rates of 28% on "intermediate goods and services" must be reduced to 18%, with any resulting revenue reduction justified as a short term fiscal stimulus, which will lead to better compliance and revenue realization after a year or so.[7] The GST council must also start thinking of a drastically simplified GST with a 3 slab System (one base rate, basic food, health, education as exempt sectors & surcharges on 6-12 carefully selected goods & services) and eliminate new bureaucratic procedures urgently. Simplification is essential for reaping the potential productivity benefits (1-2% of GDP) of GST and for reducing compliance cost for honest small industry and trade.

Government should expeditiously complete already launched reforms in *Bankruptcy law, rules* & procedures and the cleanup of the *NPAs in Public sector banks (PSBs)* announced earlier and under way. Re-capitalization should be restricted to those PSBs, which can be trusted to exercise due prudence in future lending and not run up large NPAs after recapitalization.

Net Imports of Goods and Services

Export-Import Policy & Duties

There has been virtually complete stasis on Exim reform for 5-10 years and is now over due, if we want India to become part of the global supply/value chains through which much of manufactured exports now take place. The sharp rise in Net Imports(Imports-Exports) in the first half of 2017, should surely stir the government to reform QRs and tariffs. This includes *Export-Import (EXIM)* policy (Agriculture, Textile), simplifying customs (import) duty into a uniform 10% duty on all manufactures & minerals (GST is separate).[8] Suspend the IT-electronics agreement for 3-5years (if possible). Either through EPZs or FTZ or other temporary mechanisms (5-10years) provide an opportunity to Labor intensive industries & Export Supply Chains to shift base from China to India.[9]

Reducing Education Import

Education is one of the remaining heavily controlled sectors of the Indian economy, which could provide quality education to the thousands of students forced to go abroad, and many in developing countries looking for education who are unable to come here for lack of seats.[10] This can generate high quality jobs. Central Govt. can make a start by replacing controls on higher education with modern, rational regulation (based on asymmetric information & moral hazard problems faced by users), including regulated entry for globally recognized institutions.[11] Standardization and certification of skills has to be speeded up, so that basic education is complemented by basic job skills for the large mass of students who do not have the aptitude for higher education!

Medical Tourism

Health sector is also characterized by serious problems of asymmetric information that require replacement of the limited existing control systems by sophisticated & broad based regulation.[12] This is very challenging job. A start can be made by modernizing regulatory systems in the Hospital sector which also has huge opportunities for Service exports/medical tourism. Hospitals meeting the highest regulatory standards could be linked with and closely connected with and linked to the medical tourist visa system, to facilitate quick, virtually automatic issue of medical visa, as well as to monitor misuse of this visa.

De-Control Agriculture: Create Jobs

Two consecutive normal monsoons provide an opportunity to reduce/eliminate the jungle of controls on *Agriculture and irrigation* sector.[13] Central government can eliminate all *export controls & QRs* on agricultural commodities and reduce export duties to zero immediately. If government wants to help farmers on a permanent & longer term basis, it should also repeal ECA & APMC, approve all GM seeds recommended by the GEAC & induce hold-out States to join the National e-market for all agricultural products. Remaining impediments to FDI in food retailing, and retailing of related agricultural products should also be removed. These measure will quickly boost trade and economic activity and job creation in rural areas.

LPQ Raj: Land & Labor

Reduction in Household investment in dwellings, buildings & structures is a clear reflection of unchanged Ease of Doing Business in land & real estate. Similarly, reports of lower job creation in export oriented and organized sectors reflect the lack of reforms and unchanged "Ease of Doing Business" in labor market. Reform of the two most distorted markets, labor & land, are not a 0-1 processes. They have multiple dimensions, each one badly riddled with controls, distortions and corruption. So a phased program of labor & land reform can be drawn up and implemented step by step over next five years as political opportunity permits. The atmosphere of crises created by some economists and forecasters, could provide an opportunity to reduce political constraints on reform of these two sectors.[14]

Summary & Outlook

This article has analyzed both the demand (GDP) and the supply (GVA) side of the economy since 2011-12 to identify factors responsible for the trend decline of growth in the past six quarters and the problems that have persisted from earlier years. This in turn suggests policy measures that can help reverse the negative factors and trends.

Manufacturing growth cycle peaked at the end of 2015-16 and has been down-trending since then because of the rise in real interest rates. The decline in supply of credit, because of Bank Non-performing Assets(NPAs) has added to the problem. Corporate debt ratios rose sharply between 2010 and 2014, partly because of government directed lending by Public sector banks (PSBs) and partly because over-optimistic forecasts of global and domestic recovery. Tightening regulations since 2014 have made them more transparent and forced Banks to acknowledge and account for them.

The rising real interest rates since 2014, have also attracted excessive amounts of debt capital inflows, raising the REER and making undifferentiated products and labor-intensive (LI) manufacturing less competitive and raising net imports (imports-exports). Rising real interest rates have also had a negative effect on *construction* and Gross fixed capital formation (GFCF) by Households and un-incorporated enterprises (HH), reducing demand for dwellings and buildings. The tension between reduced corruption and laws & actions against Black money and the continued corruption in land policy & real estate regulatory systems at the State and Municipal levels (which continue to demand bribes) has also reduced demand, both directly through reduced availability of black money and heightened fear of use of white money for black transactions. It has also acted indirectly by deflating the prices of an asset traditional characterized by steady inflation. There is no longer an expectation that value appreciation and real return through appreciation in the value of these properties.

The analysis of this paper suggests that demonetization disrupted the domestic manufacturing supply chain and thus diverted demand into imports. Investment in structures and construction slowed and temporarily halted. Stocks were also drawn down during and after demonetization. Agriculture which was recovering solidly from two consecutive droughts, was affected by input supply-output purchase processes in Q1 of 2017-18, because of slow replenishment of demonetized cash. These factors reduced GDP by about 1.2% in H1 of 2017. Most if not all the negative effects of de-monetization are now behind us and consequently GDP growth has likely bottomed out in 2017-18 Q1. An anticipation of GST starting on July 1 also led to running down of stocks in prior months (ie Q1 of 2017-8) because of fears of getting shortchanged on input credit from GST (and a possible slowdown in production even before that). High frequency data suggests that some of this destocking has started reversing in August, though permanent level of stocks may in future be below earlier ratios because of GST costs. The complexity created by new bureaucratic procedures in GST, multiple rates on same goods & services, and multiple rates in general, has raised compliance costs and created uncertainty for small trade and industry, which may, reduce GDP growth a notch lower in Q2. The GST council must not stand on prestige in rectifying the avoidable complexity in the GST system as implemented.

The economy will bottom out in Q1 or Q2 2017-18, but the speed of recovery will depend on Monetary policy and Government's effort to reduce uncertainty (created by exogenous shocks and endogenous policy actions) and to expedite fiscal, external (Agriculture QRs & tariffs, textile's specific duties, education service import, health service export) and domestic reforms (agriculture decontrol, land & labor). The feeling of crisis created by forecasts of growth decline below 5.7% and talk of impending recession/depression, shouldn't lead to panic over-reaction, but can perhaps be used to weaken earlier political constraints on reforms. The reforms outlined in this paper can help accelerate the GDP growth recovery in 2017-18 and beyond. As of now, GDP Growth is likely to be below the forecast of 7.5% (mean), but within the range of 6.75% to 8.25% that I had forecast at the beginning of the financial year.[15]

[1] http://dravirmani.blogspot.in/2016/11/demonetization-economics_16.html

[2] http://dravirmani.blogspot.in/2016/11/demonetization-economics_16.html

[3] Monthly Data(all india) on monthly wages of male rural workers (obtained from RBI data base) converted to growth rate of real wages by subtracting average rural CPI growth for relevant periods, shows the following results for average (y on y) real wage growth in 2017 H1 compared to 2016 H1: 11 of 13 agricultural jobs showed acceleration, while one showed a deceleration (picking workers). 10 of 12 general/non-agricultural jobs showed acceleration, while 2 showed deceleration(weavers).

[4] Monetary policy generally assumes a transmission lag of 18 months from policy change to economic effects.

[5] Please note that value of manufactured exports can increase with appreciation if the price elasticity of demand for aggregate manufactured exports is >-1. This is not inconsistent with a decline in competitiveness of Labor-Intensive(LI) export production (with price elasticity < -1) viz Vietnam, Bangladesh, Cambodia etc.

[6] Proposed in author's chapter on tax reform in book edited by Bibek Debroy and Ashok Malik, "India at 70, Modi @3.5".

[7] https://www.facebook.com/arvindvirmani2/posts/780808875419702

[8] AV, "Towards a Competitive Economy: VAT and Customs Duty Reform," Planning Commission Working Paper No. 4/2002-PC, April 2002. http://www.planningcommission.nic.in/reports/wrkpapers/wp_vat.pdf ; Arvind Virmani, "Customs Tariff Reform," Economic and Political Weekly, Vol. XL No. 11, March 12-18, 2005, pp. 1006-1008.

[9] Further details in tax reform chapter of forthcomng book: India at 70 years, Modi at 3 years

[10] http://dravirmani.blogspot.in/2015/06/educate-in-india-ease-of-educating.html

[11] The Right to Education Act(RTEA), by increasing bureaucratic controls and forcing NGO-NPO schools to pay higher salaries than their endowments and charitable donations can afford, have already led to closure of several schools. Net result will be a reduction of school access for the poor and vulnerable and zero quality improvement for the rest.

[12] Price controls on medical equipment will bring temporary relief and long term harm as both high quality imports and import substitution cease. Similarly price controls on drugs and pharma will reduce internal R&D in new drugs and favor cheap Chinese imports.

[13] https://sites.google.com/site/chintan1997reg/economic-policy-and-regulation/agriculture

[14] https://sites.google.com/site/chintan1997reg/economic-policy-and-regulation/land , and https://sites.google.com/site/chintan1997reg/economic-policy-and-regulation/jobs-employment

[15] http://dravirmani.blogspot.in/2017/03/gdp-2016-17-and-2017-18-forecasts-cso.html , http://dravirmani.blogspot.in/2017/02/monetary-policy-8217.html