Addressing the Economic Slowdown

What is the issue?

- India is currently witnessing a notable economic slowdown as reflected in the automobile slump and employment problems.
- In this context, boosting growth requires that attention be paid to both cyclical and structural dimensions of the problem.

What are the key factors behind?

- India’s current economic slowdown is due to a combination of two underlying trends.
- First, there is the short-run cyclical slowdown exhibited by a number of high-frequency indicators.
- There is a significant fall in demand, especially for sectors such as automobiles, consumer durables and housing.
- Second, there is the more serious long-term fall in investment and savings rates.
- Raising growth requires that attention be paid to both cyclical and structural dimensions of the problem.

How is the fixed capital formation scenario?

- The Gross Fixed Capital Formation (GFCF) relative to GDP at current prices has had a steady fall since 2011-12, when it was 34.3%.
- By 2017-18, it had fallen by 5.7% points, to a level of 28.6%.
- Assuming an Incremental Capital Output Ratio (ICOR) of 4, this meant a fall of nearly 1.4% points in the potential growth rate.
- [ICOR is the ratio of investment to growth; higher the ICOR, the lower the productivity of capital or the marginal efficiency of capital.]
- The fall consisted of sectoral decreases in the household, private corporate and public sectors.

<table>
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<tr>
<th>Sector-wise Gross Fixed Capital Formation (as % of GDP) at current prices (2011-12 base series)</th>
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<tbody>
<tr>
<td>Total</td>
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<td>Public</td>
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<td>Private corporate</td>
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<td>Households</td>
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• **Sectoral trend** - The fall in the household sector’s investment rate got arrested by 2015-16.
  
  • However, by then, the rate had already fallen by 6.3% points.
  
  • From 2016-17, the sector’s investment rate even showed some recovery.
  
  • In contrast to the household sector rate, the private corporate sector investment rate did not show any fall up to 2015-16.
  
  • At 11.9% then, it was in fact higher than the corresponding rate for 2011-12 (11.2%).
  
  • It fell in the subsequent years, but only by 0.7% points.
  
  • In the case of the public sector, the rate fell by 0.3% points between 2015-16 and 2017-18.
  
  • Thus, the period from 2011-12 to 2017-18 can be seen as consisting of two parts:
    
    1. 2011-12 to 2015-16, when the household sector investment rate fell sharply
    2. 2015-16 to 2017-18 when the investment rates of the private corporate and public sectors fell marginally

**What is the case with the savings rate?**

• The Gross Domestic Savings Rate fell between 2011-12 and 2017-18 by 4.1% points, from 34.6% of GDP to 30.5%.
• However, this fall was entirely due to the household sector.
• The private corporate and public sectors show increases in their savings rates by margins of 2.2% points and 0.2% points, respectively.

**What is the overall implication?**

• This differentiated sectoral pattern of investment and savings rates had significant implications for the financing of investment.
• Private corporate and public sectors were the deficit sectors.
• They usually financed their deficits from the surplus savings of the household sector.
• In addition, net inflow of foreign capital added to the flow of investible resources.
• But throughout the period from 2011-12, the savings rate of the private corporate sector increased.
• This reduced its dependence on the surplus savings of the household sector.
• The excess of private corporate sector’s investment over its own savings rate was 3.8% points of GDP in 2011-12.
• [However, this gap fell to 0.5% points by 2017-18.]
• Given this pattern, private corporate sector’s investment demand can be largely met by its own savings.
So, at present, all the surplus savings of the household sector is available for the public sector.
Public sector’s borrowing requirements can be fully financed using the surplus from the household sector.
This can safely be supplemented by net inflow of foreign capital without any fear of crowding out.

What is the key priority now?

- In 2018-19, the real GDP growth rate was 6.8%.
- Two critical policy challenges need to be addressed.
- First, a countercyclical policy should increase growth rate to its current potential of 7%-7.5%.
- After this, structural reforms should raise the potential growth itself to above 8.5%.
- These are essential for India to attain a size of $5 trillion by 2024-25.

How then should expenditure be managed?

- From the monetary side, reducing the repo rate by a cumulated margin of 110 basis points in 2019 has not as yet induced a noticeable growth response.
- Given this, complementary fiscal stimulus, in the form of additional public sector investment, may prove to be more effective.
- However, given the fiscal deficit constraint, there is limited flexibility for increasing centre’s capital expenditure directly.
- There may be some expansion, if additional dividends from the Reserve Bank of India (RBI) flow to the government.
- Further, there may be some possible additional disinvestment.
- However, care should be taken to deploy all of these additional funds for capital expenditure.
- **Caution** - Normally, the prescription to meet slowing demand is to increase government expenditure.
- In the current situation, increase in government expenditure has to be directed towards an increase in investment expenditure.
- A similar effort may be made by State governments and non-government public sector enterprises to increase capital expenditures.
- All these measures may also crowd in private investment.
- Thus, this fiscal push, together with the already-initiated monetary stimulus, may help raise the growth rate.
- Another area that needs immediate attention is the financial system, which must be activated to lend more.
What are the much-needed structural reforms?

- Structural reforms are now a key priority to push the economy onto a sustained high growth path.
- On the fiscal account, there has to be a re-look at the Fiscal Responsibility and Budget Management (FRBM) Act.
- The government should actually move towards reducing the revenue deficit to zero.
- This can happen if the Centre focuses more on items on the Union list.
- Once this is achieved, the Central Government will have the freedom over fiscal deficit, as the entire deficit will be directed towards meeting capital expenditures.

Source: The Hindu

Quick Fact

Gross Fixed Capital Formation (GFCF)

- GFCF is essentially the net investment; it measures the net increase in fixed capital.
- It is a component of the Expenditure method of calculating GDP.
- Gross fixed capital formation includes:
  i. spending on land improvements
  ii. plant, machinery, and equipment purchases
  iii. the construction of roads, railways, private residential dwellings, and commercial and industrial buildings