Growth post-demonetisation

Connecting the dots

Any increase in nominal GDP that is consumption-driven, not investment-driven, must be celebrated with caution

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The attention attracted by the GDP estimates for the third quarter (Q3) of FY17 released by the CSO on February 28, 2017, would perhaps have no precedent. The debates around the numbers suggest that the contractionary impact of demonetisation on growth is suppressed by projecting a 7% Q3 growth rate. In this context, we need to keep three things in mind: (a) First, the quantum of real economic activity is captured by Gross Value Added (GVA). Gross Domestic Product (GDP) is obtained by adding taxes and subtracting subsidies from GVA. Second, certain sectors have a strong seasonal attribute like agriculture, while others do not. Thus, it makes sense to compute quarterly growth in agriculture in a particular fiscal year with that of previous years. For instance, comparing Q3 figures of FY17 with Q3 figures of FY16 will give a fair picture of growth in the sector. Computing growth in Q3 over Q2 of the same fiscal year can lead to spurious conclusions—for instance, the real growth in agriculture in Q3 over Q2 for FY17 is 70.41%, which defies any meaningful explanation. However, for other sectors like mining and quarrying, growth in Q3 over Q2 of the same fiscal year would be more pertinent for analysis. Third, the numbers of either GVA or GDP should be analysed at a disaggregate level to comprehend the reasons behind the 7% growth rate.

We first look at GVA and its sectoral composition in Q3 of FY17. The four sectors that accounted for 70% of total gross value added are *agriculture, forestry & fishing* (20%), *financial, insurance, real estate and professional services* (19%), *manufacturing* (18%), and *public administration, defence and other services* (13%). Real GVA grew by only 2.07% in the third quarter of FY17 over FY16, driven primarily by growth in *agriculture, forestry & fishing* and *public administration, defence and other services*. Agriculture recorded 6.04% growth in Q3 FY17 over Q3 FY16 *vis-à-vis* -2.2% growth in Q3 FY16 over Q3 FY15. This phenomenal growth in agriculture in Q3 was on account of the normal south-west monsoon following two consecutive drought years.

Another sector where growth in Q3 this fiscal year has been more than the corresponding growth in Q3 last year is *public administration, defence and other services*. Compared to 7.5% growth in Q3 FY16, the growth in this year's Q3 is 11.87%. The key indicator of this sector is the Union government's revenue expenditure net of interest payments (comprising payments of government employees, pensions, subsidies, grants, etc). In the accompanying graphic, we look at the monthly figures of revenue expenditure of the Union government (net of interest payments) for Q3 FY16 and Q3 FY17 for better understanding. We see that there has been a sharp rise of 32% in revenue expenditure from September 2016 to October 2016.

However, the two sectors expected to bear the adverse consequences of demonetisation have, in fact, responded likewise. First, real GVA growth in *manufacturing* in Q3 dipped by 3.87% compared to the previous quarter, while it shows an increase of 8.3% when compared with Q3 FY16. However, the CSO estimates show GVA from quasi-corporate and unorganised segment has a small share (21.5%) in the manufacturing sector. Despite this, the real GVA has indeed fallen from ₹494,773 crore in Q2 to ₹475,618 crore in Q3. This is corroborated by the findings of the Reserve Bank of India's Industrial Outlook Survey (IOS) which indicated a decline in business sentiment on account of sharp slowdown in bank credit to industry and continuing sluggishness in the investment climate in some sectors. Second, negative growth of 27.39% was recorded for *financial, insurance, real estate and professional services* in Q3 over the preceding quarter, and even percentage change in GVA growth over previous year was only 3.14% in FY17 compared to 10.4% in FY16. This sharp decline can be attributed to the near stagnation in the property market, long considered a black money safe haven, which was hit hard by demonetisation. Given the fact that real estate and professional services have a large share of 71% in the total sector, this slump in growth is understandable.

Analysing the growth in GDP in the third quarter of FY17 from the expenditure side, we see that the growth in GDP (in current prices) in Q3 over Q2 is 2.6% while the growth in Q2 over Q1 in the same fiscal year was 4.4$. Thus, while there has been nominal growth in Q3, it is 1.8 percentage points less that the growth in Q2 over Q1, and reflects a slowdown in economic activity in the third quarter. The growth in expenditure in the third quarter however, is mainly on account of rise in *private final consumption expenditure* (PFCE). A staggering growth of 11.03% in Q3 over Q2 this fiscal year seems questionable in the wake of demonetisation that supposedly squeezed liquidity out of the system given the cash crunch. However, a deeper analysis into the issue suggests that the growth in PFCE was propelled by two factors: festive season and the award of 7th Pay Commission (implemented by the Centre on August 1, 2016). The spurt in spending on account of these can help explain the low neutralising effect demonetisation had on private spending, and hence on overall expenditure as PFCE constitutes 60% of total expenditure. At this juncture, it is important to take cognisance of the fact that buoyancy provided b PFCE to GDP may persist over the com ing quarter as well with many state promising to implement the 7th P award w.e.f. January 1, 2017. What i worrisome is the fact that while *gros fixed capital formation* (GFCF) ir creased in nominal terms over th quarter, as a rate of GDP it decline from 27.9% in Q3 FY16 to 26.7% in Q FY17. Even the Second Advance Est mates of National Income and Exper diture on GDP, FY17, suggest that GFC as rate of GDP is 26.9% in FY17, the low est figure in the last six years.

GFCF as a per cent of GDP has bee declining over the years. Any increas in nominal GDP that is consumptior driven rather than investment-drive must be celebrated with caution as i jeopardises sustainable growth i the future.

It is also important to note tha downward revisions of Q3 figures c FY16 to conceal the adverse growth e fects is not true especially when sucl revisions in GDP numbers have hap pened in the past as well (for instance Q2 figures of FY13 were revise downwards twice). We thus see tha while the numbers seem counterintu itive to the perceptions held by al post the event of demonetisation, it i too early to make a comment on th impact of demonetisation on growtl May be next quarter data will giv more insights!

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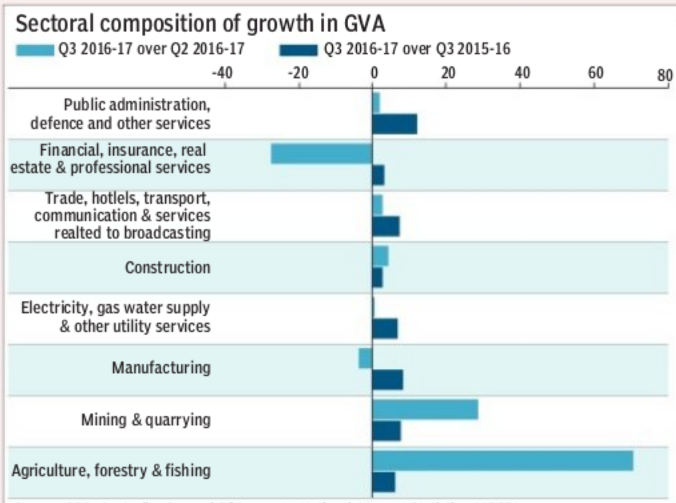
Views are persona



Source: CSO, Controller General Of Accounts, National Account Statistics, MOSPI