Demonetisation & the informal sector

The growth forecast

The economy was already slowing down and demonetisation compounded the problem

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> **A careful analysis of the growth trends, excluding agriculture and public administration, shows that the economy actually slowed down from 6.9% in the first half of the year to 5.8% in the third quarter**

The growth estimates put out by the Central Statistical Organisation (CSO) in the Second Advance Estimates of National Income for the year and the third quarter estimates have raised many eyebrows. As against the *Bloomberg* consensus estimate of 6.1% for the quarter, the CSO's estimate shows the growth of 7%. The second advance estimate of GDP for FY17 is 7.1%, which takes account of the effect of the note-ban, and is exactly identical to the first estimate. In fact, both the Reserve Bank of India as well as the Economic Survey put out by the Union ministry of finance have admitted to the fact that the note-ban would have adverse impact on growth and the latter speculates the reduction in the growth by 0.25-0.5%. The growth estimate remaining unchanged at 7.1% in the second advance estimate has led some to erroneously conclude that demonetisation has not had any significant impact on the growth rate while others have raised suspicions on the estimate itself. The fact is that there has been an effect and this is revealed by the analysis of growth composition of different sectors. Besides, as stated by the chief statistician, TCA Anant, the impact of the note-ban is yet to play out completely. Thus, there is no need either to be jubilant about the note-ban nor is there any case for stating, "lies, damn lies and statistics!"

From the policy perspective, it is important to note that the growth rate of GDP in the current year has decelerated significantly over the previous year from 7.9% to 7.1%. The deceleration in the gross value added (GVA), which is the real measure of economic activity, has been much sharper, from 7.8% to 6.7%. Except for agriculture and public administration, the growth rate was either stagnant or declined by various magnitudes in other sectors. In agriculture, thanks to the bountiful monsoon, the growth is estimated to have accelerated from 0.8% in FY16 to 4.4% in the current year, and in public administration, thanks to the pay revision, the growth rate increased from 6.9% to 11.2%. The sharpest decline in the growth was in mining (from 12.3% to 1.3%), financial and real estate sector (from 10.8% to 6.5%) and manufacturing (from 10.6% to 7.7%).

More importantly, the gross domestic capital formation (GDCF) has shown a steady decline from 29.2% to 26.9% (in current prices). This is really a matter of concern as the estimate is the lowest in the last 15 years. Sustained acceleration in growth rate is possible only when the investment climate improves and that underlines the urgency in solving the twin balance sheet problem. The third quarter estimate of growth for FY17 at 7% as against the *Bloomberg* consensus estimate of 6.1% has raised many eyebrows. The estimate of growth in private consumption at 11.1% in the third quarter over the previous one has only added to the confusion. While some have questioned the legitimacy of estimates, others have argued that the note-ban had no impact on economic activity! A close scrutiny of the estimate shows that the conclusion that the note-ban has had no impact on economic activity would be erroneous. There are a number of reasons for this. First, the note-ban affected only the latter part of the quarter and its effect is not confined to the quarter alone. We will have to see how the economy fares in the next quarter as well. Second, much of the impact of the note-ban has been on the informal sector and small and medium industries. The data set from ministry of corporate affairs and the Index of Industrial Production (IIP) on which manufacturing GDP estimate is based mainly captures the trend in the formal sector and the informal sector numbers are projected based on these. It is only when more detailed information on them comes in will we get a better picture. It must be stated that the GDP estimates undergo revisions for almost two years. Third, the impact of the note-ban cannot be assessed on the basis of simple trends. That can be assessed only in counter-factual terms, i.e., what would have been the growth in the absence of the note-ban. In other words, in the absence of the note-ban, the growth rate in some of the sectors could have been higher if there was no demonetisation. Even so, the financial and real estate sector grew at only 3.1% in the third quarte, as against 7.6% in the previous, and similarly, the construction sector grew at 2.7% as against 3.4% in the previous quarter. In fact, the high growth was mainly on account of agricultural sector which is estimated to register 6% growth in the quarter as against 3.8% in the previous quarter and -2.2% in the third quarter of the previous year. Another sector which showed a sharp surge in growth is mining, which accelerated to 7.5% in the third quarter as against -1.3% in the previous. Similarly, the note-ban has nothing to do with the acceleration in the growth of manufacturing (from 6.9% to 8.3%) or public administration (from 11% to 11.9%). Despite this, as mentioned earlier, the GVA according to the second advance estimate for FY17 at 6.7% is lower than the first advance estimate put out in early January (7%). A careful analysis of the growth trends, excluding agriculture and public administration, shows that the economy actually slowed down from 6.9% in the first half of the year to 5.8% in the third quarter, which gives sufficient evidence of the adverse impact. This is clearly more than one percentage point slowdown even when the demonetisation impacted only in the second half of the quarter. Indeed, as mentioned above, the full impact of the measure will be known only when the revised estimates come in.

The simple point is that the economy was already slowing down on account of the poor investment climate, and demonetisation compounded the problem. While the disruption caused by demonetisation will be overcome with passage of time as the economy gets remonetised, the government will have to address the poor investment climate in the country to arrest declining investments and credit off-take. Hopefully, action on this front will happen soon.

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