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# The economic outlook in a period of political uncertainty

*Despite the prevailing political uncertainties, growth has been reviving both at the global level and within India*

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We are in a period of high political uncertainty both at home and abroad. The uncertainty inevitably spills over to the economic sphere. Nevertheless, within this uncertain landscape, it is still possible to discern some fairly robust trends, some positive and others not so positive.

At home, the Gujarat election has dominated the headlines for weeks. One of the most distressing aspects of the election campaign is the unspeakably coarse language to which political discourse descended. Another aspect was the capturing of the political narrative by issues of identity, caste and religion. Those of us who would like to see elections fought and won on social and economic policy issues will be unhappy about this turn of politics. However, in the prevailing climate of rank opportunism and populism, this may not be an altogether bad thing. By leaving serious policy issues out of the hurly-burly of an election campaign, politicians may have inadvertently protected policymaking from falling prey to such opportunism and populism.

By way of illustration, the only policy issue that was highlighted in the electioneering, apart from the administrative mess in implementing demonetization, was the goods and services tax (GST). The present design of the tax is flawed, requiring much rationalization, and rolling it out without proper preparation has imposed a huge compliance burden on the taxpayer. But basically the GST is an excellent tax, implemented in some 130 countries around the world, and its introduction is a very important piece of reform. Everybody knows this, and the GST was originally put on the reform agenda by the Congress party. Yet the Congress' Rahul Gandhi chose to lampoon this tax as the Gabbar Singh Tax to gain brownie points with the trading community, an important constituency in Gujarat, which is unhappy with it.

The Gujarat results are yet to be declared. But whatever the outcome, it will have far-reaching implications for the general elections of 2019 and beyond. Nobody expects the Congress and its allies to win. The uncertainty being pondered is the margin of the Bharatiya Janata Party's victory, whether it will remain intact, or shrink, and how that will affect the dynamics of national politics. An interesting aspect of that dynamic too is the distancing of policymaking from populist politics. The 2019 general election is less than a year-and-a-half away. Conventional wisdom would suggest that by now the political business cycle would have kicked in and any serious reform agenda should be giving way to populist agendas and fiscal profligacy. But that has not happened.

The Central government seems to be trying to come to grips with the twin balance-sheet problem that has hobbled credit flow and private investment. Following the decision to recapitalize banks, the government has also tightened the bankruptcy code to prevent defaulting promoters from reacquiring their hollowed out companies at throwaway prices. It has also appointed a committee on direct tax reform, a major agenda that had been shelved for the past three years. Further, as I discuss below, the government is undertaking strong expenditure compression, presumably to meet its fiscal deficit target. Has something changed? Can we dare to hope that the pace of reform will be sustained through the full tenure of the government? What impact will that have on growth and employment?

These questions cannot be answered based on domestic factors alone. India is now well integrated with the larger global economy and its economic outlook has to factor in conditions in the major hubs of the global economy: the US, the European Union (EU), Japan and China.

The distancing of economics from politics seen in India is also evident at the global plane. The world has become extremely fragile geopolitically in recent weeks, thanks mainly to the actions of US President Donald Trump. In reneging on the nuclear deal with Iran and pressuring it in collaboration with a Saudi-led Sunni alliance and Israel, he has increased tensions in West Asia. In East Asia, his exchange of taunts and threats with North Korean leader Kim Jong-un has effectively provoked the North Koreans to accelerate the development of their nuclear programme, successfully testing a missile that can reach most targets in the US. Through these actions, Trump has escalated global geopolitical uncertainty and instability to a level that has not been seen since the end of the Cold War.

However, such political adventurism seems to have had little impact on global economic trends. The International Monetary Fund's October World Economic Outlook (WEO) has forecast global gross domestic product (GDP) growth at 3.6% in 2017, up from 3.2% in 2016. Among the major hubs of the global economy, actual growth in the US in 2017 may exceed the WEO forecast of 2.2%. This is because the forecast was followed by the Trump tax reform, which is regressive but pro-business and may have a positive growth impact at least in the short run. In the EU, despite important structural imbalances and strong differences among countries about reform priorities, economists are now quite upbeat that there will be sustained economic recovery led by the German growth machine. Conveyed to me in a personal communication from Prof. Michael Landesman of Johannes Keplar University, Linz, this optimism is also reflected in the WEO forecast for 2017 being raised to 2.2% from 1.8% in 2016. The 2017 growth forecast for Japan at 1.5% is also higher than the 1% recorded in 2016. The 2017 forecast for China also remains high at 6.8%; in fact, it is a tad higher than the 6.7% recorded in 2016, despite persisting concerns about the fragility of the financial sector in China.

Thus, political uncertainties notwithstanding, India's economic growth is supported by a relatively buoyant global economic environment. Unfortunately, Indian exporters have so far not been able to take any advantage of the recovery in global growth. Export growth at 1.2% during the last two quarters is lower than that recorded during the preceding four quarters. With imports far exceeding exports, India's net balance of trade amounts to a net leakage of aggregate demand, which has a negative impact on growth.

## Changes in quarterly gross domestic product (expenditure)

(% change at 2011-12 prices)

| Item | 2016-17 over 2015-16 | | | | 2017-18 over 2016-17 | | Expenditure of GDP Q2 2017-18 | |
|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Rs billion (2011-12 prices) | % of GDP |
| Private final consumption expenditure (PFCE) | 8.4 | **7.9** | 11.1 | **7.3** | 6.7 | **6.5** | 17,060 | **53.9** |
| Government final consumption expenditure(GFCE) | 16.6 | **16.5** | 21.0 | **31.9** | 17.2 | **4.1** | 3,963 | **12.5** |
| Gross fixed capital formation (GFCF) | 7.4 | **3.0** | 1.7 | **-2.1** | 1.6 | **4.7** | 9,152 | **28.9** |
| Change in stocks | 8.9 | **5.9** | 6.3 | **3.5** | 1.2 | **6.7** | 770 | **2.4** |
| Valuables | -13.8 | **-21.7** | -20.0 | **-14.3** | 204.8 | **5.0** | 754 | **2.4** |
| Exports | 2.0 | **1.5** | 4.0 | **10.3** | 1.2 | **1.2** | 6,157 | **19.4** |
| Imports | -0.5 | **-3.8** | 2.1 | **11.9** | 13.4 | **7.5** | 6,792 | **21.5** |
| Trade balance (6-7) | -36.6 | **-59.3** | -30.8 | **1523.2** | 295.6 | **69.3** | | |
| Discrepancies | -45.8 | **-31.2** | -370.3 | **68.5** | -12.1 | **62.0** | 593 | **1.9** |
| GDP | 7.9 | **7.5** | 7.0 | **6.1** | 5.7 | **6.3** | 31,657 | **100** |

GRAPHIC: PRAJAKTA PATIL/MINT

Source: Ministry of statistics and programme implementation

**The Central government seems to be trying to come to grips with the twin balance-sheet problem that has hobbled credit flow and private investment**

In an earlier column (*Mint*, 15 September 2017), I had compared Indian growth to the flight of a six-engine plane where one engine is going full throttle while the other five are slowing or shutting down. International trade is one of those five engines. The engine that was going full throttle earlier was government final consumption expenditure (GFCE). However, the second quarter (Q2) of 2017-18 saw a sharp compression in public expenditure. It grew by only 4.1% compared to 17.2% in Q1 (*see table*). Private final consumption expenditure (PFCE), which is the largest component of aggregate demand at 54% of GDP, has also been slowing down consistently since the third quarter (Q3) of 2016-17 (*see table*).

What then are the positive factors driving the growth recovery? Prior to the 6.3% growth recorded in Q2 of 2016-17, growth had been consistently declining during the previous five quarters (*see table*). Thus the growth cycle seems to have bottomed out and the economy is now in a recovery phase. This is quite remarkable considering that private consumption growth is slowing down, government expenditure is being compressed and the trade deficit has widened by another 69% in Q2 of 2017-18 compared to the corresponding period in 2016-17.

One positive component is stocks, which grew by 6.7% in the last quarter after a sharp slowdown during the previous two quarters. However, this effect is quite small compared to total GDP and could also be transient, strong re-stocking post launch of GST after the de-stocking that occurred during the run up to it. A more substantive factor is gross fixed capital formation (GFCF) or investment. This component accounts for about 29% of aggregate demand and grew by 4.7% in the last quarter after having slowed down during the previous four quarters.

This is a very significant development since non-recovery of the private investment cycle has been the most important factor underlying the growth slowdown in recent years. Hopefully, it is a signal that the cycle is beginning to revive. That being said, it should be pointed out that any growth projection of over 7% for the current year would be quite unrealistic. With an average growth of 6% registered during the first half of the year, an annual growth rate of over 7% would require growth of over 8% during the second half of the year. With all the growth drivers except private investment and stocks slowing down, this seems quite unlikely. Growth for 2017-18 will probably be somewhere in the range of 6.5% to 7%. The Reserve Bank of India and the IMF have both projected that the economy will grow at 6.7%, which seems just about right.

Compared to the outlook for growth, that for employment is much gloomier. Though robust estimates are not available, it is generally believed that the real estate sector and small - and medium enterprises were the worst affected by demonetization and the roll-out of GST. There is also some evidence to support this contention. As I had pointed out in my earlier cited column, these are low-productivity, labour-intensive sectors. Their share of total output, about one-third, is much lower than their share of employment, which could be around 80%. As such, the effect of the slowdown on employment in these sectors will be far more severe than the impact on GDP growth.

I have suggested in this column that economics and politics have been moving on different tracks. Despite the prevailing political uncertainties, growth has been reviving both at the global level and within India. But employment is the intersection at which politics comes face to face with economics. Politicians can ignore the challenge of rising unemployment and underemployment only at their own peril.

*Comments are welcome at views@livemint.com*