Demand, supply and growth slowdowns

There is an ongoing debate about whether the current slowdown reflects a demand- or supply-constrained economy. Analytically, this question is pertinent when a slowdown is cyclical. If aggregate demand is less than potential output, then the economy is demand-constrained. But if actual output is less than potential output, despite the existence of aggregate demand, then it can be termed a supply-constrained slowdown.

Structural slowdowns are more complicated. In the case of a developing country such slowdowns are attributable to specific factors (lack of infrastructure, over-regulation, etc.) but may equally be a consequence of interplay between demand and supply factors.

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Demand is a function of the price at which goods and services are offered. Supply side constraints may result in equilibrium prices being so high that aggregate demand is limited. This happens when these constraints lower productivity, and therefore, prices are too high for aggregate demand to be generated at the scale required to support output growth. With no barriers to trade, such demand could also be met through increased imports, which would not contribute to raising domestic output and growth.

I see this interplay in India as follows. The Indian growth story since 1991 has not been about export-led growth except at the margin. It has been powered by domestic consumption and derivative investment demand. In essence, the relative prices of the commodities that the top 150 million people consume have fallen since 1991. Relative to the incomes of this segment of the population the prices of goods that are seen as the "leading indicators" of economic growth — cars, fast moving consumer goods, air travel etc.— have fallen continuously, as a consequence of liberalisation, rising incomes and capital gains accruing to this segment, and adequate availability of producer and consumer credit to these sectors. As I have argued previously, there is evidence that aggregate demand growth from this segment is tapering off.

However, structural barriers continue to limit aggregate demand for the things consumed by the next 300 million. Thus, mass market textile imports from Bangladesh and Vietnam absorb Indian aggregate demand as domestic industry is not able to move out of high-wage islands to competitive low-wage geographies in northern and eastern India. Despite government being the largest landowner in the country, especially in cities, regulatory and institutional barriers limit the utilisation of this land to produce affordable housing at scale. Indians earning the minimum wage are unable to afford quality health and education without subsidies.

Thus, aggregate demand for things that those earning the minimum wage wish to purchase is squeezed by high prices due to supply side constraints. High logistics costs, expensive and unreliable energy supply, poor investment in human capital, and in research and development, ineffective and discretion-based regulation and administration, lack of coherent and consistent medium-term fiscal and credit policies compound the problem by lowering productivity, increasing costs, and further limiting the scope for increasing the output of these goods and services at scale and quality.

The public policy response has been unsatisfactory. The poor and minimum wage earners alike have to make do with rationed and subsidised access to these goods of very inferior quality. This, at best, limits their welfare loss but does nothing for growth. This leads to high transaction costs and demands for priority in access to these scarce resources or expensive opt-outs. For this reason, public servants and law makers are compensated generously in kind— access to AIIMS medical facilities and expensive private healthcare at subsidised prices, preferential access to quality public housing etc. These perquisites of office ensure they are unaffected by rationing at the expense of the general public.

The current slowdown has been ascribed by many commentators to various structural shocks in the financial and credit markets, as well as medium-term shortcomings in the investment-credit relationships that have governed Indian growth over the medium term. Various measures have been suggested to improve credit off-take, liquidity, and the attractiveness of investment. There is a lot of merit in these arguments but, in my view, the current slowdown has signalled that my diagnosis of the underlying structural weakness of India's growth story needs to be addressed even though it may not be the leading proximate trigger.

I have, elsewhere, argued that short-term measures to ameliorate the slowdown are necessary. The government has done a lot to secure this amelioration using the instruments at its direct disposal. I have also suggested that more could be done by deploying monetary and credit policy instruments that would be part of any structuralist or new-Keynesian toolkit, but have fallen into disuse due to the obsession of the now discredited orthodox macro-economic framework with the mono-variate relationship between output, growth and inflation.

But for India to complete its development transformation, a switch to a broad-based and more inclusive composition of domestic demand is of the first importance. This is a medium-term task, but execution must commence with simultaneous short-term amelioration measures. If this is not done, short-term fixes will, ultimately, only result in stagflation. India needs to design incomes and industrial policies that secure a more broad-based and inclusive growth process, if it is not to fail in its development transformation and fall into some version of the middle income trap that has been the fate of many countries that have been inattentive to this problem.

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