Slowdown in India: Part 1

This article is based on **"How and why the Indian economy is losing its growth momentum"** which was published in The Indian Express on 18/12/2019. It talks about the reasons for the current slowdown in the Indian economy.

The recent collapse of India's economic growth momentum is nothing short of a mystery. This is because until just a few years ago (until March 2017) the Indian economy was not only growing at a progressively rapid pace but was also the fastest-growing major economy in the world.

In order to scrutinise what led to the slowdown in India, there is a need to analyse four drivers that determine a country's GDP.

GDP can be stated as a sum of four factors, i.e. GDP = C + G + I + (NX).

- The total expenditure (demand) by private individuals (represented by C).
- The total expenditure (demand) by the Government (represented by G).
- The total expenditure (demand) on investments made by businesses in the country (represented by I).
- The net effect of imports and exports (represented by NX).
- A country's GDP can grow by one or all of these factors.

The whole story of India's economic rise and slowdown can be explained by looking at how each of these variables performed over the past decade.

The fast growth of the Indian economy even after the Global Financial Crisis (GFC) of 2009 can be attributed to various factors:

- The Indian economy appears to have largely avoided the GFC as the GDP growth rate dipped in 2009 but it was soon back up to 9% - 10% in the succeeding years (2010 and 2011).

- Between 2009 and 2013, companies were in no position to invest and India's exports were reduced because of a decline in global demand.
  So, the "I" and "NX" component of the above equation became weak.
- However, **robust demand from the other two components** – C and G, buoyed up the economy during this phase.
  - During 2015 and 2016, **international crude oil prices fell to a third** of what they were in 2014.
  - This essentially meant that **Indians could spend more** and the "C" component of the equation boosted the GDP.
  - This gave a **1-1.5 % boost to India's GDP.**
- In 2017 world demand increased accompanied by a **real depreciation of the rupee,** amounting to about **13% in real effective terms** by late 2018.
  - As a result, non-oil export growth rose from **-8.6 % in 2015-16 to 8.9 % in 2017-18.**
  - Therefore, the "NX" component helped bump up the GDP growth.
- Moreover, the GDP growth boosted by **increased government spending** (the "G" component) on many social sectors schemes.
- India's growth was boosted by a **lending spree provided by <u>non-banking financial companies (NBFCs)</u> like IL&FS and DHFL.**
  - NBFCs took over the **leading role of lending to the economy** because banks were still struggling with NPAs and were largely unwilling to lend directly to businesses.
  - The credit provided by NBFCs fuelled both private consumption (C) and business investment (I), and through this route fuelled GDP growth.

What derailed the Indian economy after 2017?

- **Former Chief Economic Advisor, Arvind Subramanian**, argued that the Indian economy is facing both structural and cyclical challenges.
  - **Structural challenges:** Long-term issues related to the overall framework of the economy such as the flexibility or inflexibility of labour laws etc.
  - **Cyclical challenges:** Short-term issues such as a bad monsoon that disrupts the production of food articles etc.
  - Since the causes are both structural and cyclical, arresting this economic slowdown is proving to be so difficult.
  - The **measures that would have alleviated a cyclical slowdown fall flat because structural reasons** are also involved.
- He also held that the **unresolved Twin-Balance Sheet (TBS) Problem** accompanied by the **fall of NBFCs** and the **real estate sector,** together make for the **Four Balance Sheet Challenge** of the Indian economy (i.e Banks, Corporates, NBFC, Real estate).
  This four balance sheet **challenge suppressed the I component in the country.**

- **Four Balance Sheet Challenge**
    - **Twin-Balance Sheet problem**
        - Economic Survey of 2017-18 noted that the economy was facing a TBS problem.
        - The two balance sheets it referred to belonged to the **Indian banks** (especially public sector banks or the government-owned banks) and the **corporate sector,** respectively.
            - Balance sheets of Indian banks were burdened by a **high proportion of non-performing loans** and the balance sheet of corporates were **clogged because they had over-borrowed** and were unable to pay.
            - The origins of India's TBS can be traced to the economic boom that happened between 2005 and 2009 (the period when the Indian economy was growing at near double-digit growth rates).
            - The banks, especially the government-owned ones, ignored prudential norms and lent a lot of money to companies in the hope that this would help boost economic growth.
            - Companies borrowed heavily in the hope of making profits in the future.
            - However, the economic prospects collapsed quite sharply after the Global Financial Crisis of 2009 and a high proportion of companies found that their projects were no longer viable.
        - The end result was that the companies were left with huge loans that they could not pay back in time and the banks were left with huge loans that had turned into NPAs.
    - **IL&FS crisis** was a setback for the **whole NBFC sector.** With Rs 90,000 crores of debt, its failure sent shockwaves throughout the financial system.
    - **The real estate sector also suffered as** builders launched numerous projects since the start of the mid-2000s in the hope that these flats would be sold up eagerly.
        - However, after the Global Financial Crisis, the demand for flats, as well as bank funding for builders, collapsed.
        - By June-end 2019, the real estate sector reached a breaking point with close to 10 lakh unsold units (as against an annual demand of just 2 lakh units) in just the top 8 cities in the country.
        - The real estate sector was unable to pay back to the NBFCs, which, in turn, started defaulting.
- The trade component (NX) was weak because the global demand for India's goods was down.
- **Consumption (C component) which has been the major driver** of growth in the Indian economy is facing a slowdown due to **Income stagnation in India.**

Drishti Mains Question

Discuss the factors responsible for the current slowdown of the Indian economy.

Note: *Kindly follow the subsequent part of this article in the second part of “Slowdown in India”.*