PGDM (RM), Batch 2019-21
Macroeconomics for Retailers
RM - 303
Trimester – III, End-Term Examination: June 2020

Case Study 1 (30 marks)

Tackling India's economic slowdown – Financial Year 2019-20

India's GDP growth has decelerated to 4.5% in the second quarter. Neither consumption nor export and private investment are supportive. In fact, India's economic growth is being driven by government expenditure. Excluding the government part that comprises not more than 13%, the Indian economy grew just 3.05% in the July-September quarter. Therefore, things are much worse than what headline growth number suggests. Slowing GDP growth will lower tax collections, and even cap the government's ability to spend and support growth.

The government has been hinting that the global headwinds are behind sluggish exports, and this is not without reason. US President Donald Trump has removed India from the US GSP (Generalized System of Preferences) beneficiary list, with adverse implications for export items such as chemicals, pharmaceuticals and engineering goods. The American tightening of immigration rules dampens Indian information technology (IT) export prospects. The European Union (EU) is struggling with Brexit, and slowing growth in its larger economies such as Germany. The Middle East—another major export market for Indian merchandise—is troubled by its over-reliance on oil and the regional political turmoil. Supply chains are now sourcing more locally than before. All of these developments are bound to affect India's exports.

However, what the government is not telling—and which it rather should—is that India's merchandise exports have been hovering around $300 billion for a very long time. The figure stood at $305 billion in FY12, and it will be no different in FY20. Obviously, the problem is internal mismanagement. Countries such as Bangladesh and Vietnam are fast replacing India in the products the latter has traditionally dominated; for example, apparels. India's textile majors such as Arvind and Raymond are silently shifting their production base to Ethiopia to take advantage of cheaper labour and electricity, and duty-free market access in top consuming markets. Vietnam, in fact, is far ahead of India in attracting top electronics manufactures and, in turn, it is now pushing electronics exports as well.

Similarly, a number of factors are responsible for the slowdown in consumption, which has fallen to 5.1% year-on-year in Q2FY20 compared to 9.8% in Q2FY19. Continuing rural distress, which was accentuated first by the note ban and then by domestic and global supply gluts, is now capping rural demand. The wholesale prices of most agricultural crops are 15-20% lower than their MSP (minimum support price), while the prices of major farm inputs and equipment have gone up by 10% or so. This is squeezing margins and, in turn, farmers' incomes and their demand for goods and services.

High taxation and regulatory rent-seeking in sectors such as automobiles and real estate are aiding the demand slowdown. For instance, effective taxation is up to 50% for automobiles. Similarly, high GST (goods and services tax) on key inputs such as cement, protectionism-induced high-priced steel along with prohibitive stamp duty and registration charges are keeping home prices inflated and the demand for them capped. This hampers the prospects of dependent industries. Rising household debts and credit crunch in the shadow banking space are further contributing to the demand slowdown. No wonder, investment, as measured by the gross fixed capital formation (GFCF), grew by a meagre 1% in Q2FY20, even as its share in GDP continued to decline.

The decline in capacity is reflected by 3.8% contraction in factory output in October—the third month in a row. Government investments, which usually bridge the gap during a slowdown, started losing steam as state governments' capex—which makes up the major share of public investments—has shrunk in the last two quarters.

Nevertheless, a 15.6% increase in government expenditure in the second quarter, compared to 10.9% in the same quarter last fiscal, has contributed one-third of the 4.5% GDP growth rate. However, government demand is primarily dependent upon its tax collection as it can't really borrow much without forcing interest rates to rise. That crowds out private investment.

The direct tax including corporate and personal income tax grew 5% in the period April-September 15, compared to the same period last year. Therefore, to achieve the budgeted target of 17.3% in FY20, it must grow by a whopping 27%—which is highly unlikely. GST collection remains muted due to slowing growth and low base—only 1.2 million out of the 62 million companies are GST-registered. Given this backdrop, badly-timed corporate tax cut will further limit the government's ability to spend and support growth. And if that was not enough, recent disruptions related to amendments in the citizenship Act and national registry will hurt economic activities and hamper growth.

Going forward, the government can do the following to revive consumer demand. The GST Council should increase GST on low GST items with inelastic demand, and reduce GST rates for high GST items with elastic demand. That will reduce rate differentials and discourage GST evasion and corruption. That will also boost the overall consumer demand. As reviving demand remains the key to reviving private investment, reducing income tax rates for lower-income people, if not for all, can be a big sentiment booster.

Keeping import duties high, especially on key industrial raw material such as steel or polyester and synthetic fibres, hurts downstream industries and induces import of high-value finished goods—this adds to the import bill. Similarly, a stronger rupee encourages imports and hurts exports. Therefore, a weaker rupee rather than high import duties will provide protection to domestic manufacturers and yet improve India's export competitiveness. In addition, liquidity situation in the shadow banking space must improve. One key supply-side measure that can help even in the short term could be a genuine attempt to reduce the compliance burden for SMEs.

1) With reference to the abovementioned article, what are the reasons stated for the slowdown in the economy?
2) How does consumption, investment, government expenditure and net exports impact GDP of a country? Discuss.