GDP Contraction

Why in news?

The Ministry of Statistics and Programme Implementation (MoSPI) released the data for the first quarter (Q1) of the current financial year.

What does the data reveal?

- Most observers expected that India's GDP contraction would not exceed 20% in the first quarter (April, May, June).
- [GDP - Final value of the goods and services produced within the geographic boundaries of a country during a specified period of time.]
- As it turns out, the GDP contracted by 24% in Q1.
- Almost all the major indicators of growth in the economy - production of cement or consumption of steel - show deep contraction.
- The data quality is sub-optimal because of the widespread lockdowns.
- Most observers expect this number to worsen when it is revised in due course.

What is the biggest implication?

- With GDP contracting by more than what most observers expected, it is now believed that the full-year GDP could also worsen.
- Since economic liberalisation in the early 1990s, Indian economy has clocked an average of 7% GDP growth each year.
- This year, it is likely to turn turtle and **contract by 7%** for the full financial year.
- Data show that barring agriculture, where the gross value added (GVA) grew by 3.4%, all other sectors of the economy saw their incomes fall.
- [GVA - A proxy for production and incomes]
- The worst affected were construction (–50%), trade, hotels and other services (–47%), manufacturing (–39%), and mining (–23%).
- It is important to note that these are the sectors that create the maximum new jobs in the country.
- In a scenario where each of these sectors is contracting so sharply, it would lead to a decline in employment or rise in unemployment.

What causes GDP contraction?

- In any economy, the total demand for goods and services i.e., the GDP is generated from one of the **four engines of growth**.

- The biggest engine is consumption demand from private individuals (C).
- In India, this accounted for 56.4% of all GDP before this quarter.
- The second biggest engine is the demand generated by private sector businesses (I) and this accounted for 32% of all GDP in India.
- The third engine is the demand for goods and services generated by the government (G), and it accounted for 11% of India's GDP.
- The last engine is the net demand on GDP after we subtract imports from India's exports (NX).
- In India's case, it is the smallest engine and, since India typically imports more than it exports, its effect is negative on the GDP.
- So total GDP = C + I + G + NX

How did these engines perform?

- Private consumption has fallen by 27%.
- The demand generated by private sector businesses has fallen even harder - it is half of what it was last year same quarter.
- So the two biggest engines, which accounted for over 88% of Indian total GDP, saw a massive contraction in the Q1.
- The NX has turned positive in this Q1 because India's imports have crashed more than its exports.
- The last engine of growth, government's expenditure went up by 16%
- But this was nowhere near enough to compensate for the loss of demand (power) in other sectors (engines) of the economy.
- The government spending increased meagrely that it could cover just 6% of the total fall in demand being experienced by people and businesses.
- It is the lower level of absolute GDP that is making the government look like a bigger engine of growth than what it is.

What is the way out?

- When incomes fall sharply, private individuals cut back consumption.
- When private consumption falls sharply, businesses stop investing.
- Since both are voluntary decisions, there is no way to force people to spend more and/or coerce businesses to invest more in the current scenario.
- The same logic holds for exports and imports as well.
- Under the circumstances, there is only one engine that can boost GDP and that is the government (G).
- Only when government spend more, can the economy revive in the short to medium term.

What is holding back the government from spending more?

- Even before the Covid crisis, government finances were overextended.
- It was not only borrowing but borrowing more than what it should have.
- As a result, today it doesn't have as much money.
- It will have to think of some innovative solutions to generate resources.

Source: The Indian Express