OVERHEATED OR LACKING HEAT? − Swaminathan Aiyar, February 27th, 2013, Economic Times

The Indian economy presents a puzzle today. On the one hand, it exhibits many symptoms of overheating. On the other hand, many businesses complain of a complete lack of heat. GDP projections reflect the second phenomenon, not the first. But I suspect data revisions will ultimately show GDP to be somewhat better than suggested by the latest dismal estimates. ` The current account deficit in 2011-12 was 4.2%, and the fiscal deficit was 5.9% of GDP (against the budgeted 4.8%). Both were signs of overheating. Moreover, consumer price inflation was almost in double digits, and every sector from agriculture and construction to industry and services complained of labour scarcity.

These trends have continued in the current financial year. The current account deficit came in at a record 5.4% of GDP in the second quarter of 2012-13, and Citibank estimates the annual number at 4.7%. The fiscal deficit would have been as large or larger than last year's but for recent Herculean efforts by P Chidambaram to slash spending (mostly productive Plan spending), and by deferring many payments (like dues to oil and fertiliser companies) till the next fiscal year.

Inflation has continued high through most of the fiscal year. Wholesale price inflation has at last dipped to 6.6% in January, but consumer price inflation remains sky-high at 10.8%. Complaints of scarce labour have not weakened.

In sum, we have had signs of an overheated economy for two years. Yet, in the same period, we have also seen a dramatic fall in production, consumption and investment intentions, and overall economic sentiment. These are all signs of a flagging economy, and point in the very opposite direction of overheating.

After hitting 9.2% in 2010-11 —largely because of a big recovery of agriculture after a drought in the preceding year — GDP growth crashed to 6.5% in 2011-12. The CSO now projects it at just 5% in 2012-13 —implying a still lower figure of 4.7% for the second half of this fiscal year. Even this sombre CSO projection assumes industrial growth of 3.1% for the year, whereas actual growth of the index of industrial production in April-December was a pathetic 0.7%. Even worse was the performance of exports, which declined 4.6% during April-January.

Other macro figures also show terrible weaknesses in the economy. The CSO projects private consumption this year to rise by only 4.1%, after consistently exceeding 8% in recent years. Growth of public consumption is projected to slow to 4.1% this year from 4.4% last year. Fixed capital investment growth is projected to slow to 2.5%, from 4.4% last year and double-digit figures in the boom years.

How do we reconcile the data showing overheating with data showing terrible weakness? Some economists claim that high inflation proves that India is supply-constrained. But many corporates complain of slack demand and low capacity utilisation, above all in the capital goods sector.

Fuel shortages have affected power production. Yet, the paradox is that power generation has done perfectly well this year, with around 5% growth. This has not translated into higher manufacturing, so presumably power shortages have eased. In the past, manufacturing grew twice or faster than power generation. That relationship has suddenly reversed.

We have no really good explanation why an investment rate of around 35% of GDP — and higher power generation — has suddenly stopped translating into strong growth of production. A partial explanation comes from CMIE, which says the number of stalled projects has shot up. Because of this, new project proposals have plummeted. That explains the falling order book for capital goods. But it does not prove a generalised collapse of demand.

Some economists say the problem is stagflation — a mixture of stagnation and inflation — arising from deep structural problems. In the 1970s, many western countries attempted to use large Keynesian deficits to stimulate growth, but ended up stimulating inflation — hence the phrase stagflation.

However, this is not a good description of what's happening in the country. Despite the slowdown, 5% GDP growth is surely too fast to be called stagnation. The fiscal deficit is indeed translating more into inflation and imports than domestic production. Yet, stagflation typically means high unemployment, whereas India is experiencing labour shortages.

One day, data revisions will give us a better grasp of the situation. I suspect the production data will be revised upwards as the finance minister has claimed.

The latest trends in Purchasing Managers Indices suggest an upturn. And FMCG companies had 15% sales growth during September-December, a modest slowing rather than a crash in demand.

Economies rarely crash from 9% to 5% growth unless there is a crisis, war or natural disaster. India has not faced any such disasters. Its longterm economic drivers remain intact. Seen in perspective, its current performance looks too bad to continue long. The factors stalling projects and causing delays are being addressed, and environmental and other clearances are being expedited. This should soon lead to an upturn in the economy. This amounts to an optimistic interpretation of the paradox of overheating and heat loss at the same time.END My Rejoinder is on the next page

<u>Both Overheated and Lacking Heat (</u>Financial Express, March 18th, Vivek Moorthy)

On the day the Finance Minister presented the Budget in Parliament, it was also reported that GDP growth for October-December 2012 grew at 4.5%, its lowest in a decade. It is now likely that growth for the full fiscal year will come in around 5% or lower, way below the 9% growth that many felt had become the "new normal". At the same time consumer price rise by most measures has been in double digits for over a year, and in fact rose a lot last year while GDP growth fell.

The combination of a weak economy and high inflation can be broadly termed stagflation. The phenomenon became widely recognized and the term came into vogue after OPEC raised crude oil prices four fold in October 1973 and, subsequently, GDP fell in USA and other developed economies, while inflation soared. The macroeconomic outcomes were attributed to the OPEC induced supply shocks, while the term itself was often attributed to the noted Keynesian economist Paul Samuelson. It bears pointing out that the word 'stagflation' was first used in November 1965 in the British Parliament by Iain Macleod, then shadow Chancellor of the Exchequer. More crucially, robust evidence indicates that the OPEC explanation of the mid 1970s stagflation is flawed.

Swaminathan Aiyar (henceforth called Swami, for brevity) in his article a day before the Budget analyzes this phenomenon of falling GDP growth, coupled with high inflation. He first argues that the situation is not one of stagflation because India is still growing at a substantial 5%, whereas during 1973-75 output *fell* in USA and other countries. More crucially he points to India's labour shortages indicating overheating, while stagflation should entail high unemployment. His overall conclusion seems to be that the economy is more overheated than lacking heat, and he conjectures that the GDP data will get revised upwards. ("Overheated or Lacking Heat?", Economic Times, Feb 27th, 2013)

His overall conclusion can be questioned. For starters, Swami has correctly identified and grappled with the somewhat paradoxical and difficult present situation. By contrast, the Economic Survey released the same day does not broach the topic of stagflation, let alone examine it. A quick scan reveals no mention of the 'S' word.

Nevertheless, like many others analyzing India's economy at present, Swami has missed out on the ramifications of the inflation adjusted Phillips curve, perhaps the most important concept in macroeconomics. I will later explain, based on the dynamics of the Inflation Adjusted Phillips Curve, henceforth labelled IAPC , how an economy can display symptoms of overheating and yet also lack heat (The textbook term for IAPC is Expectations Augmented Phillips Curve).

Swami's first point -- that 5% growth is too high to constitute stagflation-- is definitional. Granted, the term came into use following the drop in output in USA of 1973-75 when inflation soared. But a drop from say 2% growth to minus 1% in USA, is quite similar to a drop from say 8% to 5%, as in India at present. In both cases GDP growth falls by 3 percentage points; the economic impact is broadly similar. In characterizing stagflation, we should pay attention to the magnitude of the drop, and not get fixated on the absolute benchmark of zero, used to officially define a recession in USA.

In general, comparing different sectors, an economy can be both overheated and lacking heat, as currently in India. At one level, there are two economies: that of (rural) *Bharat* and (urban) *India*. Due to massive welfare spending, *Bharat* has been sizzling while the manufacturing sector and corporate *India,* is now wilting. As an aside, the Bollywood blockbusters of yesteryear were mostly set in five star hotels, now they are mostly filmed in *Bharat*.

However, the *Bharat-India* dichotomy is not the main reason for the economy to reflect both the consequences of overheating and also lack heat. While the weakness of growth in 2011-2012 was mostly in capital goods expenditure, for the fiscal year just ending (2012-2013) the slowdown in growth, and more so the sub components of Consumption in the GDP accounts is very broad based, well documented in the latest Economic Survey. The exorbitant growth in rural welfare spending has somewhat tapered off. Sectoral imbalance is not the problem.

Instead, we need to examine the IAPC. The IAPC implies that when an economy grows faster than its potential, the economy overheats and so inflation rises. This inflation gets embedded in wage and other contracts which, in turn, slowly works its way into further inflation. Then when the economy slows down, and aggregate demand falls relative to aggregate supply, this weakness puts downward pressure on inflation. <u>Nevertheless overall inflation will rise if the upward push from inflation adjustment (first variable in the IAPC) exceeds the downward pull from a weak economy (second variable in the IAPC).</u>

To take a numerical example , suppose GDP growth falls from 9% to 5%, and this fall lowers inflation by 2 percentage points. Simultaneously, suppose expected inflation − due to past overheating and also the reaction to ongoing diesel price hikes − rises by 3 percentage points. On balance, inflation will rise by 1 percentage point along with the large drop in growth, which is a case of mild stagflation.

These opposing effects are partially manifest in the huge divergence between the inflation measure that has been the stated and most often actual focus of policy (WPI non food manufacturing, what the RBI thinks is "core" inflation, around 4% now) and the CPI. The latter reflects a wide range of items that directly or indirectly incorporate inflation adjustment, is now running close to 11% all India. From the RBI survey, expected inflation has been above 11% in recent quarters.

Conceptually, the occurrence of stagflation can be explained as purely due to monetary tightening in response to an overheated economy, *without* any supply shock. Indeed, interest rate hikes to ward off the inflation contributed to a mini stagflation in USA between 1967/1968 to 1970, well before OPEC's actions.

Returning to India's economy, it should be emphasized that the occurrence of stagflation does not depend on ***why*** growth has fallen. The huge drop in investment, which started the process, could have been because the RBI raised rates and tightened since early 2010, or due to other autonomous reasons – be it 'policy paralysis', bruited by Dr Kaushik Basu, or real business cycle factors such as technological gestation lags in capital goods, the bunching of orders (as for durable goods), or over expansion of capacity and market saturation, as for telecom connections.

My own view, in sync with the mainstream, is that some combination of all these factors have led to the downturn. But this does not have much connection, if any, with the stagflation. A comparison of India with China is quite informative. China's economy has also been slowing after several years of double digit growth, as its enormous investment boom has tapered off, and as the People's Bank of China has been using various policy tools over the years to curb rising property prices. But as the Table shows, China's inflation ending December 2012 has ***fallen,*** along with slowing growth. This is what normally happens when growth slows, and has also happened in most other ASEAN economies, where policy makers in recent years did not allow much overheating, if at all.

As an auxilliary matter, the role of policy paralysis, like that of Mark Twain's reported demise, seems to have been greatly exaggerated. As Swami has pointed out, unlike in the past, power generation has grown faster than manufacturing, so power generation cannot be the main bottleneck. A comparison of the volume of unused coal block allotments versus pending or rejected applications for such blocks would be informative in this regard. Text 1288 Words

	Calendar Year GDP Growth*		Change**	Calendar Year CPI Inflation*		Change**
	2011	2012		2011	2012	
India	6.9	4.5	-2.4	8.4	10.7	2.3
China	8.9	7.9	-1.0	4.5	2.5	-2.0

*For Q4 (Oct-Dec) measured over year ago, CPI measured Q4/Q4 for India, Dec-Dec for China. **Change in GDP growth and CPI measured in percentage points.

*Note: This article draws upon a seminar, "Understanding India's Stagflation" at IIM Bangalore, December 2012, Chapter 6 of the author's textbook in progress, and "Debunking Supply Shock Myths", September 2008, more details on my website **economicsperiscope.com**.*