

Implications of Q2 growth dip

REPORT CARD. Contraction in government capital expenditure in the first half played a major role in the growth decline



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Estimates of Gross Domestic Product for the 2nd Quarter 2024-25 has come as a surprise. The anticipation was some decline in growth rate. But the decline was much sharper giving rise to some concerns about the performance of the economy for the whole year. The medium-term implications are also a matter of concern.

In looking at the performance of the Indian economy in Q2, we need to note that the performance of the economy in Q2 of last year was exceptionally good at 8.1 per cent. We need to reckon with a high base which normally leads to a lower growth in the subsequent year. Looking at the expenditure components, private final consumption expenditure has grown at a reasonable rate of 6 per cent.

On the other hand, government final consumption expenditure and Gross Fixed Capital Formation have grown more modestly. In fact, government capital expenditures have shown a negative growth pulling down the growth rate of gross fixed capital formation.

In particular, GoI's capital expenditure contracted by (-) 15.4 per cent during the first half of 2024-25. Exports growth rate is also modest. Thus, from the expenditure side, the major factor contributing to the decline in growth rate in Q2 is fixed capital formation and within it, the primary factor is the decline in government capital expenditures which may have been a deliberate decision of the government.

Looking at the gross value added at various sectors, agriculture growth at 3.5 per cent in Q2 is a good performance. But the secondary sector comprising of manufacturing, electricity and construction has done badly with a growth rate of 3.9 per cent. Manufacturing in particular had a poor performance with a growth rate of 2.2 per cent. Tertiary sector has done well at a growth rate of 7.1 per cent.

Thus, from the production side the main concern is manufacturing. A slow growth rate in manufacturing has also implications for growth rate in employment.

LIKELY GROWTH RATE OF 2024-25
Given the first half real GDP growth rate



CAPEX PUSH. Capital expenditure from both the Centre and States will play a key role in boosting FY25 growth **VELANKANNI RAJ B**

of 6.0 per cent, what will be the growth rate during 2024-25?

Much will depend on government. From a policy perspective, the government must take a view on what its policy is towards capital expenditures in the second half.

In all probability, the second half will see pick up in capital expenditures. The budgeted growth in GoI's capital expenditure was 17.1 per cent. However, CGA data indicates that in the first seven months, GoI's capital expenditure contracted by (-) 14.7 per cent.

In order to realise the annual budgeted growth rate, GoI's capital expenditure would need to grow by 60.5 per cent in the remaining five months of the fiscal year. Available information indicates that, State government capital expenditures have also contracted during the first six months.

It is not known how well the scheme for increasing States' capital expenditures initiated by the union government is working. If the capital expenditures of government, the Centre

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and States together pick up, we can expect a growth rate for the year as a whole to be between 6 and 6.5 per cent in 2024-25.

The first half growth rate looks reasonable because of good performance in the first quarter. If we revise the first half growth of RBI projection and retain the projection of Q3 and Q4, the overall growth rate for the year will be 6.7 per cent. This is on the optimistic side.

Given the sluggishness in capital expenditure growth across central, state governments as well as public sector enterprises, it is likely that there would be slippage in the RBI's projected growth rates of 7.4 per cent each for Q3 and Q4. Another matter of concern relates to the low level of nominal GDP growth which is estimated at 8.0 per cent in Q2 and 8.9 per cent in the first half of 2024-25. The implicit price-based deflator (IPD) based inflation in the first half is 2.7 per cent. This is in spite of CPI inflation remaining at 4.6 per cent in the first half of 2024-25.

Clearly, it is the relatively larger weight of WPI inflation, which was only 2.1 per cent, in the construction of the IPD that accounts for such a low level of IPD-based inflation. If nominal GDP growth remains well below the budgeted level of 10.5 per cent, the growth of government tax revenues will also be subdued limiting the efficacy of any fiscal intervention later on.

Further, with recent hikes in CPI

inflation, monetary authorities may delay the initiation of a rate reduction cycle towards the end of the fiscal year, leaving the burden of uplifting the growth rate in 2024-25 almost entirely to fiscal intervention.

MEDIUM TERM IMPLICATIONS

What are the implications of Q2 growth for the medium term? It is clear that the economy cannot depend upon the stimulus provided by Government capital expenditure. Private investment, both corporate and non-corporate, must pick up. Government's capital expenditures have been maintained at a high level because of a high fiscal deficit.

Also, at present the gross fixed capital formation rate (for Q2) in real terms is estimated at 34.3 per cent. However, the average gross fixed capital formation rate over the last three years is 33.4 per cent. The incremental capital output ratio in the medium-term may be about 5.2. If this turns out to be lower, we should be able to grow at 6.5 per cent comfortably.

Thus the medium-term growth prospects appear to be in the range of 6 to 6.5 per cent. In fact, greater focus is needed to bring down the ICOR from the current high level exceeding 5.

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