Q2

Define potential GDP and explain its determinants. What are the factors that have been inhibiting India from realizing its potential GDP?

UPSC Civil Services Mains 2020 · GS III · 10 marks · Indian Economy

Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Core demand of the question

- Define potential GDP and explain its determinants. What are the factors that have been inhibiting India from realizing its potential GDP?
- Keep the explanation within a 10-mark length

Revision summary

Potential GDP is sustainable full-capacity output, not the latest quarterly print.

Determinants are labour, capital stock, TFP, infrastructure, and macro stability.

India wastes potential through low female participation, logistics gaps, and factor-market frictions.

Bank and corporate stress, weak learning, and informality hold productivity down.

Demand shocks open an output gap; scarring can also lower the ceiling itself.

Introduction

Potential GDP is the highest level of real output an economy can sustain without sparking accelerating inflation, given its labour, capital, and technology. It is a supply-side ceiling, not last quarter's print. India often runs below that ceiling because of idle workers, thin capital, and frictions that keep productivity stuck.

Body

Meaning

- **Potential GDP** (or potential output) is a trend path set by productive capacity. The **output gap** is actual GDP minus potential: negative in a slump, positive when the economy overheats.
- It is estimated, not observed - filters, production functions, and survey slack. Policy still needs the idea: stimulus that only fills a gap is not the same as reform that raises the ceiling.

Determinants

- **Labour:** working-age population, participation (especially women), skills, and health. A demographic bulge raises potential only if people work and are productive.
- **Capital stock:** machines, structures, infrastructure, and housing. Investment as **gross fixed capital formation** is how the ceiling moves.

- **Total factor productivity:** organisation, technology, cities, and institutions that let the same labour and capital yield more.
- **Land and natural capital**, energy reliability, and the **financial system's** ability to allocate saving to investment.
- Openness to ideas and competition, and a stable **macro regime** (inflation, fiscal, external) so firms invest for the long run.

What inhibits India from realising it

- **Low female labour-force participation** and still-weak job creation in manufacturing waste the demographic gift.
- **Infrastructure and logistics gaps**, power quality, and delayed projects raise the capital cost of every extra unit of output.
- **Factor-market frictions:** land acquisition, labour dualism, and stalled factor reforms keep resources in low-productivity uses.
- **Balance-sheet stress** in banks and corporates (the twin-balance-sheet years) and later NBFC stress cut credit to new capital.
- **Human capital:** learning poverty, health, and nutrition cap TFP even when diplomas multiply.
- **Regulatory and judicial delay**, policy uncertainty, and a large informal sector with thin productivity.
- **Agriculture's** disguised unemployment and water-energy distortions lock labour below its potential product.
- Demand slumps (including the **2019-20 slowdown** and then **COVID**) can leave actual GDP far below an unchanged potential, and scarring can then pull potential itself down.

Flow diagram

Potential GDP -> Labour skills participation

Potential GDP -> Capital infrastructure

Potential GDP -> TFP institutions

Frictions NPAs informality -> Negative output gap

Potential GDP -> Negative output gap

Conclusion

- **Potential GDP is capacity:** labour, capital, and productivity without inflationary strain. India under-realises it when women and youth stay under-employed, capital formation is weak, banks are clogged, and institutions slow the reallocation of land and labour. Raising the ceiling is reform plus investment, not only a rate cut.

Facts & figures

Output gap

Difference between actual and potential GDP; a guide for how much stimulus can run without inflation.

GFCF

Gross fixed capital formation: the investment flow that builds the capital stock behind potential output.

TFP

Total factor productivity: efficiency with which labour and capital combine, lifted by technology and institutions.

PLFS participation

Female labour-force participation in India has been structurally low, which caps potential labour input.

Twin balance sheets

Stressed banks and corporates in the 2010s that slowed credit and private investment.