India's Growth Story: A comparative view

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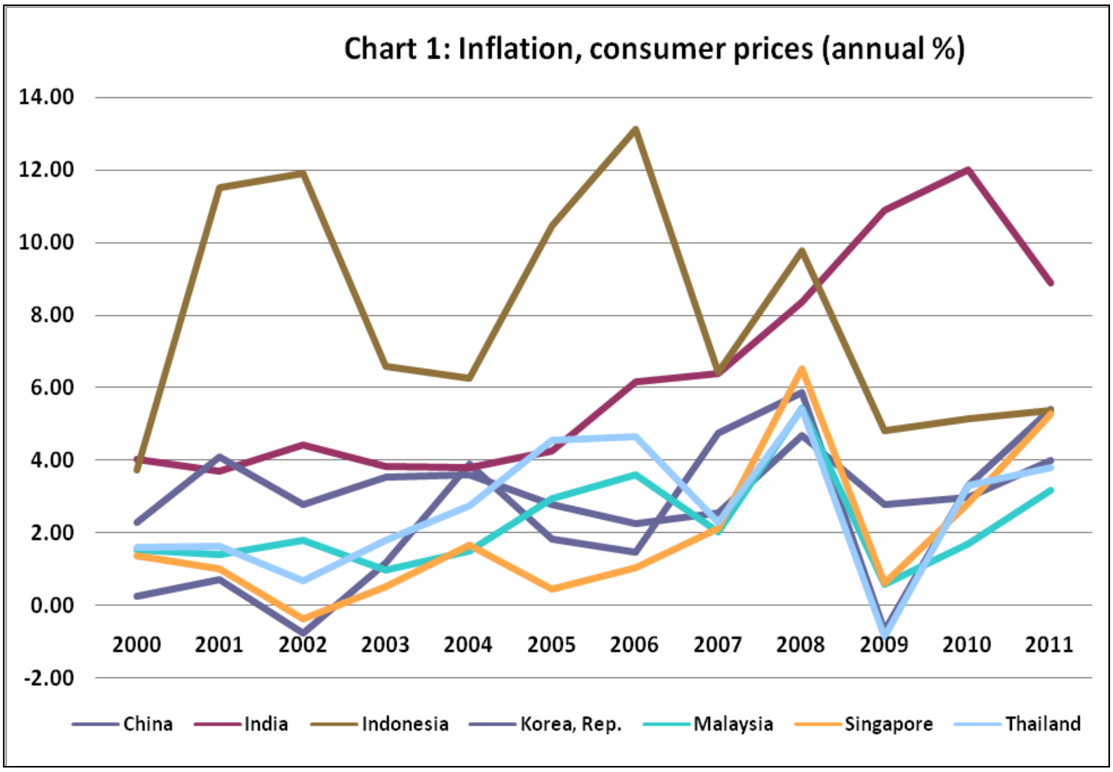
As GDP growth slows and industrial performance worsens, the government is hard put to find explanations. Part of the blame has been conveniently placed at the door of the central bank, with fingers pointed at the Reserve Bank of India's reluctance to cut interest rates that were raised to combat inflation. But the more fundamental explanations being offered are the poor performance of the global economy and the difficulty of pushing ahead with more "reform" in India's divided polity. Since little can be done about the former, the Congress Party's economic policy agenda has been focused on accelerating reform at all costs, with special attention on policies that favour foreign capital.

The argument of inadequate reform is, however, without much substance. For two decades now, successive governments have implemented neoliberal reforms in all areas of policy. In fact, whenever growth has accelerated during this period, as during 1994-1997 and 2003-2008, or when growth deceleration in India has been less than elsewhere, as during the 2008-10 global recession, "success" has been attributed to "economic reform". If those who do so explain deceleration as being the result of inadequate reform, they are being self-contradictory. Moreover, since neoliberal reform finally involves incentivising and inducing private investment, both domestic and foreign, there can be no boundary to what is "adequate". There would always be some measures that can further tilt the distribution of income and value added in favour of investors. So in all countries, whether successful or not, there are ways in which liberalisation can incentivise investment even further. Lack of success cannot be attributed to not implementing these.

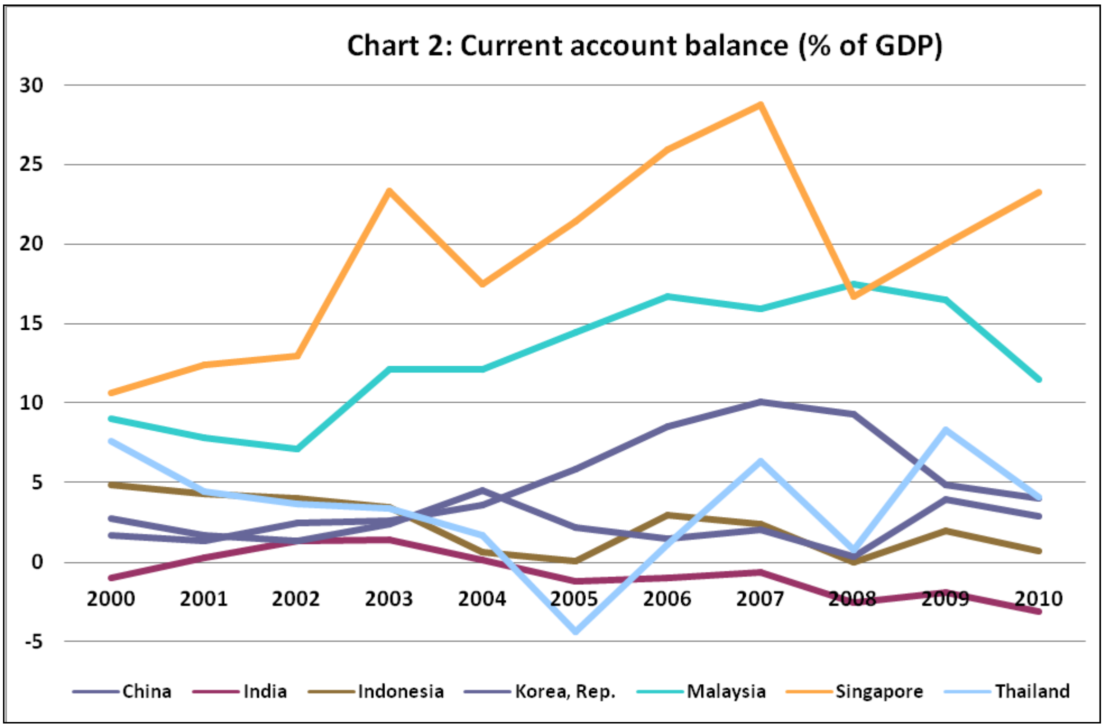
As for the impact of the global recession, India should be less affected when compared to other similarly placed Asian economies, given its significantly lower integration with the developed countries through trade. The problem must lie elsewhere. In attempting to fathom it, the comparison with other Asian countries may be usefully extended.

Besides the sharp deceleration in growth, there are other ways in which recent Indian experience differs from some other, if not all, Asian countries. Some economic indicators are of particular import. The first is inflation. As Chart 1 shows, ever since 2004, when India experienced acceleration in its rate of growth, inflation has been rising and has remained well above that in other large Asian developing countries.

Indonesia, which was experiencing much higher inflation than India during this period 2007, has since been characterised by much lower inflation. All other countries chosen for comparison (China, Malaysia, South Korea, Malaysia, Singapore and Thailand) had consistently lower rates of inflation. That is, recent growth in India has been accompanied by "overheating" of a kind.

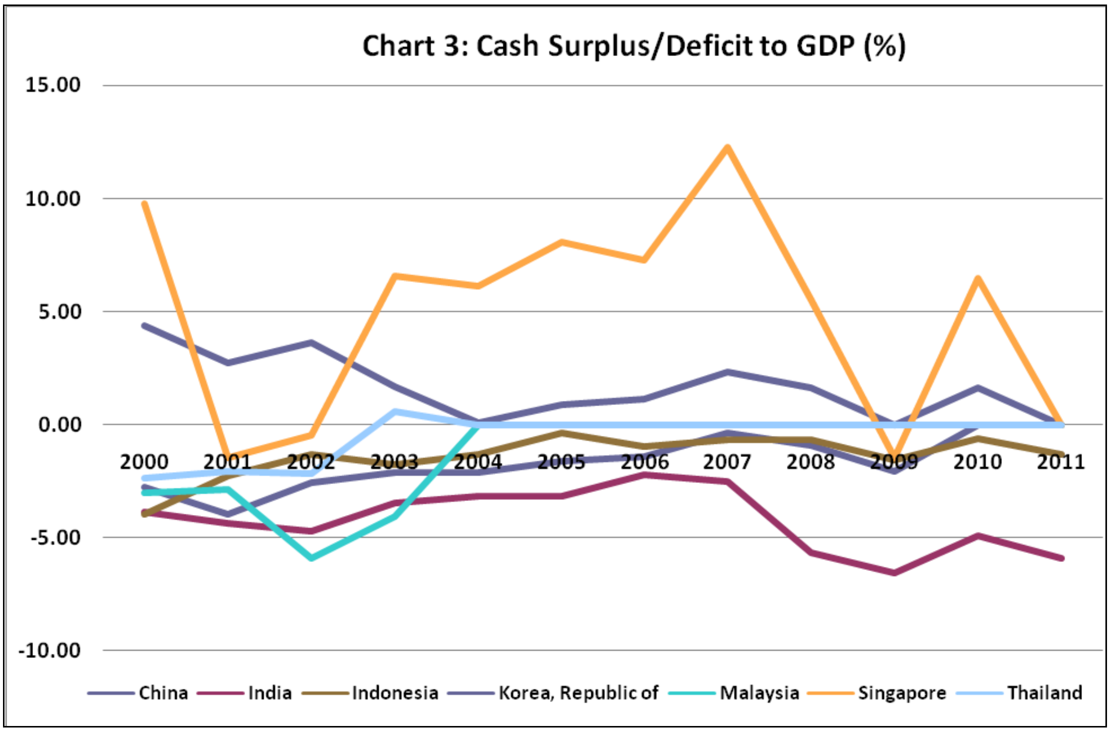


The second indicator of overheating is the current account deficit (Chart 2). Most of the erstwhile high growth Asian countries had recorded current account surpluses during the 2000s. As compared to them, India was the country that was deficit on this account for the most number of years during the last decade, and also recorded the highest current account deficits among them over a number of years. Clearly, excess domestic absorption or demand was spilling over onto the balance of payments. If - despite this leakage of excess demand to the international system - inflation remained high, it was partly because prices were also being driven by cost-push factors, besides demand-supply imbalances.



The high and rising current account deficit defeats the argument that India’s large foreign exchange reserves are an indication of her external strength and of the success of “reform”. Clearly, much of those reserves are the result of capital inflows, all of which are associated with future payment commitments in foreign exchange, and a large part of which can quickly flow out of the country. The deficits also suggest that as and when growth occurred it was driven by domestic demand rather than external stimuli, such as India’s much celebrated services export success.

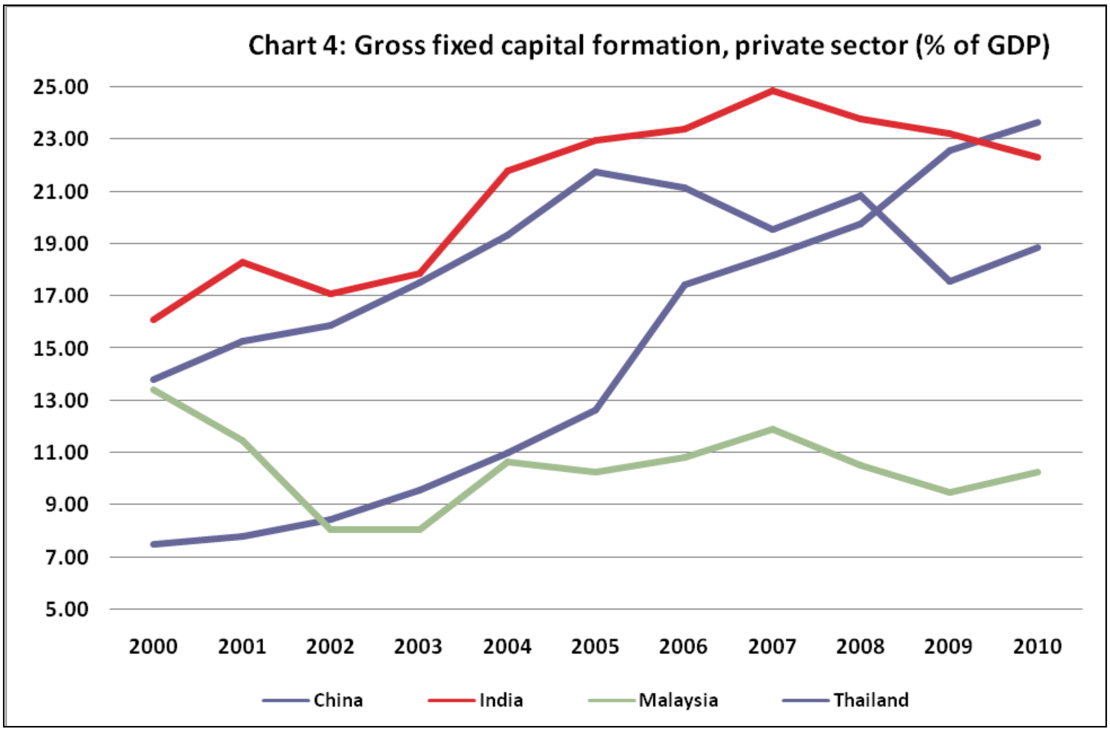
It would be useful then to turn to the nature of these internal stimuli. One of them is of course deficit- financed public expenditure. The revised IMF statistics on government finance capture the deficit in its figures on cash surpluses and deficit, with the cash surplus or deficit being defined as revenue (including grants) minus expense, minus net acquisition of nonfinancial assets. This cash surplus or deficit is the closest to the earlier overall budget (im)balance (financed through the net acquisition of financial assets). As Chart 3 shows, among the countries being compared, India had the highest cash deficit and this has been rising in recent years. This indicates that government deficit spending was one source of demand infusion that was driving growth and partly and indirectly contributing to inflation, because of supply constraints in sectors such as agriculture. The government has been claiming that the deficit is the result of subsidies on a host of commodities varying from food to fertiliser and petroleum products. But the point is, if growth is to be sustained, any curtailment of the subsidies requires them to be replaced by other expenditures (such as funding for private-public partnerships in the infrastructural area that the government is keen to provide). The deficit can be reduced only if spending is financed by increased taxation, which the government is not interested in pursuing.

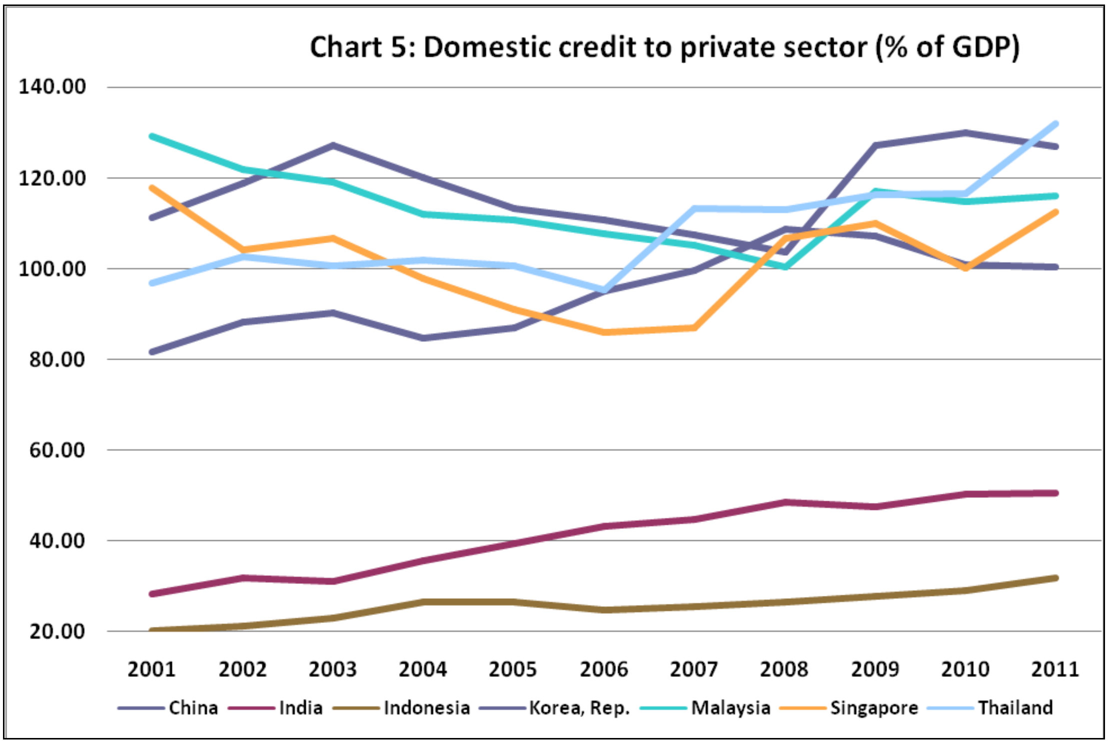


Besides public expenditure there have been two other factors that have contributed to expanding domestic demand and fuelling growth. One is the sudden and significant step up in private capital formation in India (Chart 4). Though China, which started with a much lower rate of private capital formation in 2000, has since overtaken India, the latter has maintained a higher rate of private capital formation till recently, and that has risen sharply between 2003 and 2007.

This higher rate of capital formation and higher level of private consumption expenditure has been facilitated by an expansion of credit to the private sector to finance both investment and consumption (Chart 5). Though the credit to the private sector in India as a ratio of GDP is much lower than most of the Asian countries being considered, that figure has been rising in recent years. This not only facilitates private investment in areas such as infrastructure, but provides the basis for an expansion of private consumption expenditure that stimulates demand.

However, in a relatively short period of time it has become clear that this growth trajectory is not sustainable, given its inflationary outcomes in terms of a high rate of increase in consumer prices and a widening of the current account deficit. Thus far the only response to these forms of "overheating" is a significant hike in interest rates by the Reserve Bank of India. But it is not that which has slowed growth, but the tapering off of the credit boom, since there is evidence of rising defaults.





In sum, the deceleration in growth is not solely the result of the global recession, and definitely not of the "inadequacy" of reform. Indeed, it could rather be argued that the reform measures themselves generated a process that has run out of steam, since the stimuli (including continued fiscal incentives to large private corporate sector and so on) that have delivered growth are not sustainable.

Sustained growth is not impossible, as the success of other Asian countries have shown. Nor does it have to be based only on a mercantilist export strategy, as that is not open to all. Whether growth can be sustained or not depends on how it is stimulated and financed. The Indian growth episode was not based on the sorts of stimuli and methods of financing that have characterised the growth of some other more successful Asian economies. It has therefore become a victim of its own internal contradictions.

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