Some Aspects of India's Recent Growth Dynamics and Prospects

Aggregate demand and supply

2.30 The step-up in the trend growth rate of the Indian economy since around 2003-04, highlighted in Economic Survey 2007-08 has come about due to significant improvement in our domestic investment and saving rates. The investment rate has increased from 25.2 per cent in 2002-03 to over 39 per cent in 2007-08 (Figures 2.7i, ii & iii). If one looks at the growth "drivers," at an incremental level there was a significant increase in the investment growth rate. It nearly tripled from an average of around 6 per cent in the five-year period leading up to 2002-03 to just nearly 17 per cent in the next five years. The role of private consumption was also supportive with its growth rate increasing from less than 5 per cent to nearly 7 per cent in the said periods, though its relative contribution in sustaining growth came down below that of investment for the first time. Moreover, this spurt in investment growth was primarily that of private fixed investment and not a build-up of inventories. There was, therefore, an increase in the productive capacity of the economy which in the medium term would help the economy

Fig.2.7(i) Investment Rate - GDCF as a proportion of GDPmp

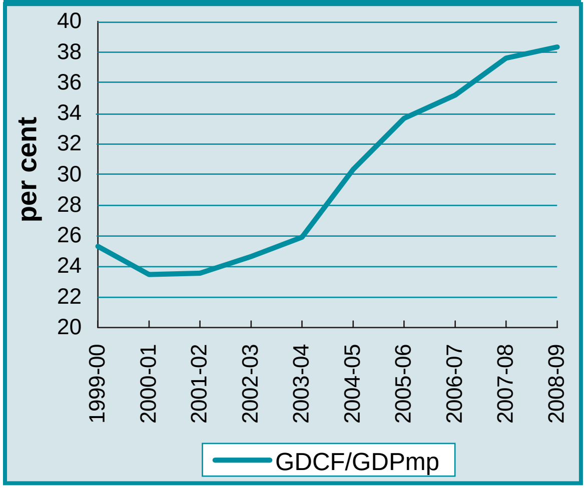


Fig.2.7(ii) Growth rate of GDPfc, investment & consumption

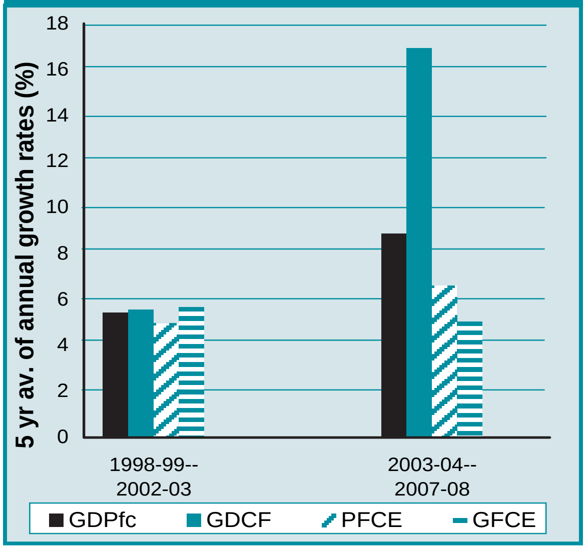
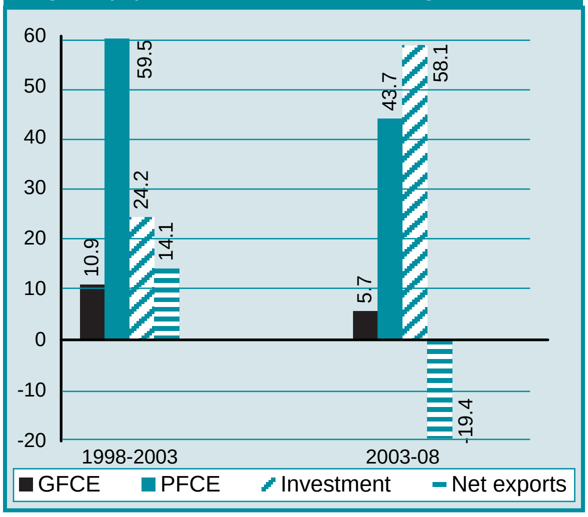


Fig.2.7(iii) Contribution to GDP growth



climb back to its trend rate. To consider one example, gross capital formation at constant 1999-2000 prices in agriculture as a proportion of agriculture GDP improved from 11.1 per cent in 2003-04 to 14.2 per cent in 2007-08. It is also worth noting, particularly in the context of the global slowdown, that the net contribution of the external sector to aggregate demand of the economy has been negative since 1990, except for a brief period, from 1997-98 to 2002-03, when it was positive and about 14 per cent. In the high growth period since then it has been negative, about 19 per cent. This notwithstanding, India's integration into the world economy over the last decade has been surprisingly rapid. For example, India's external trade (merchandise exports plus imports) as a proportion of GDP grew from 18.6 per cent in 1997-98 to 38.9 per cent in 2008-09.

2.31 In the last five years, the gross domestic savings as a proportion of GDP has increased from 26.3 per cent in 2002-03 to 37.7 per cent in 2007-08. During this period, the percentage share of public sector in gross domestic savings increased from (-)2.5 per cent to 11.9 per cent (Quick Estimates). The significant increase in the inflow of foreign capital that this period witnessed was important not so much for bridging the domestic savings-investment gap, but for facilitating the intermediation of financial resources to meet the growing needs of the domestic industry and service sector for long term and risk capital. Moreover, though domestic funds were available, they were expensive relative to foreign funding. Thus, from a macroeconomic perspective, the average current account deficit during 2003-04 to 2007-08 was 0.4 per cent of GDP, while the investment-saving gap was even smaller when viewed from the National Accounts. Even in 2007-08, which showed the highest deficit for this period, the current account deficit was only about 1.5 per cent of GDP, the rest almost 7 per cent was rechanneled abroad in the form of foreign exchange reserves. However, these capital flows in excess of the current account deficit reflect the importance of external financing and the depth of India's financial integration with the rest of the world. Indeed, India's financial integration with the world was as rapid as its trade globalization, if not more. As a broad measure of globalization, the ratio of total external transactions (gross current account flows plus gross capital flows) to GDP more than doubled over a 10-year period from 46.8 per cent in 1997-98 to 117.4 per cent in 2007-08.

Sectoral composition

2.32 In terms of sectoral growth drivers, manufacturing, communications, trade, agriculture and construction have been the major contributors to the spurt in the growth rate. During the period 2003-04 to 2007-08, the annual growth rate of agriculture was more than 4 per cent. The production of foodgrains increased by about 10 million tonnes each year to reach an all-time high of over 230 million tonnes in 2007-08. Manufacturing, registered as well as unregistered, recorded a growth of 9.5 per cent per annum and communication and construction sector grew at the rate of 27 per cent and 13.5 per cent per annum, respectively in the period 2004-05 to 2007-08. The growth of investment in manufacturing was around 30 per cent per annum. Similarly, the capital stock in end-2007-08 over end-2002-03 was nearly one-and-a-half times more in construction, manufacturing and in trade, hotels and restaurants. Some of these sectors recorded significant improvement in efficiency as captured, somewhat crudely, by improvement in the incremental capital-output ratios, benefitting from a competitive environment and technological upgradation.

Spatial dimension of the growth spurt

2.33 If one considers the period since 2000-01, the average per annum GDP growth rate at the all-India level increased substantively from 5.6 per cent in sub-period I (2000-01 to 2003-04) to 8.9 per cent in sub-period II (2004-05 to 2007-08). A total of 27 states and Union Territories out of 32 improved their performance in the sub-period II vis-à-vis sub-period I (see the states reflected above the 45 degree line in Figure 2.8i) as per the data available with CSO as of May 2009. Of these 27, nine states and Union Territories namely, Delhi, Karnataka, Tamil Nadu, Jharkhand, Bihar, Maharashtra, Goa, Madhya Pradesh and Manipur more than doubled their growth rates in the sub-period II. Chandigarh was the only state/Union Territory that maintained a two digit growth rate in both the periods.

2.34 It is instructive to look at the movement of these states and Union Territories (Figure 2.8ii) between low, medium and high growth categories in the two sub-periods. Although, Madhya Pradesh and Manipur managed to more than double their growth rates in sub-period II, it was not enough to pull them out of the low performing category, relative to the all-India average (i.e. below 4 per cent per annum in sub-period I and below 6 per cent per annum in sub-period II). In case of Rajasthan, Puducherry, Nagaland and Mizoram the high growth rates of sub-period I (i.e. above 6 per cent per annum) could not be sustained in sub-period II (i.e. above 8 per cent per annum). Indeed, these four states /Union Territories

Fig. 2.8 (i) Trend in state level growth in gross state domestic product

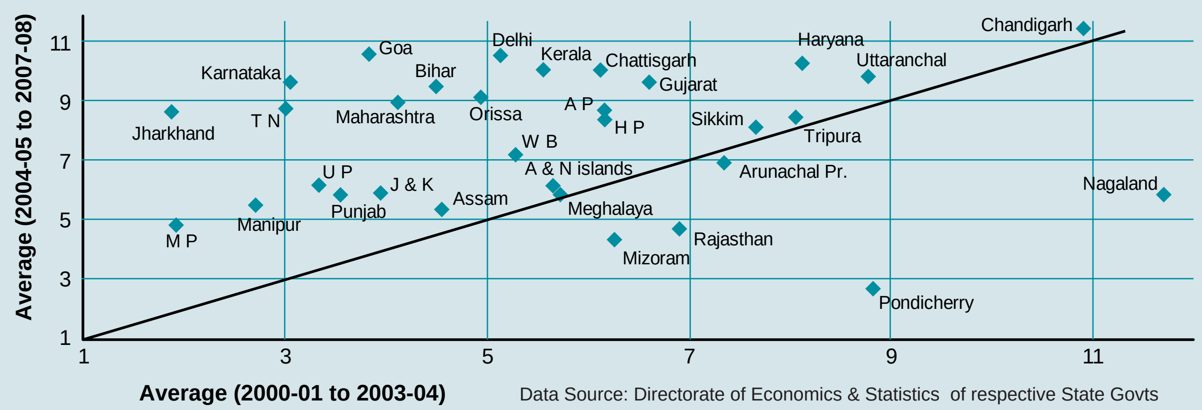
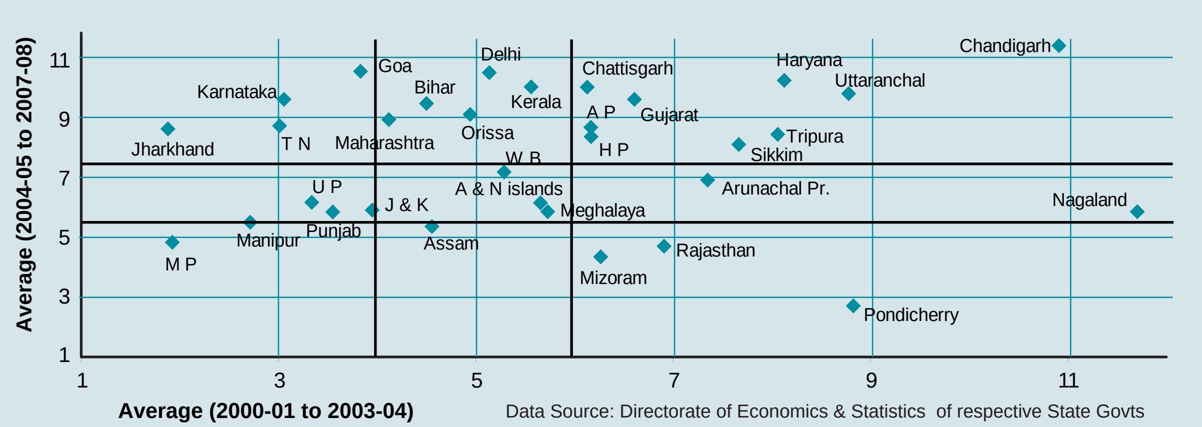


Fig. 2.8 (ii) Trend in state level growth in gross state domestic product



have slipped from high performing category in sub-period I to low performing category in sub-period II. Similarly, Assam and Meghalaya have moved from medium category (i.e. with growth rate between 4 and 6 per cent) in sub-period I to low category in sub-period II. It is somewhat of a surprise to see Punjab among the low performing states in both sub-periods, even though it improved its growth rate from about 4 per cent to nearly 6 per cent. Haryana, Uttarakhand, Tripura, Sikkim, Gujarat, Himachal Pradesh, Andhra Pradesh, Chhattisgarh and Chandigarh have retained their position in the high performing states/Union Territories in both sub-periods. While highlighting the growth transition at state level, the analysis provides an indication of the considerable scope that exists in improving growth rates in many states and Union Territories and thereby also at the national level (Box 2.2).

Box 2.2 : Growth and Poverty : Policy Implications for Lagging States

Interstate differences in improvement in poverty incidence can be largely explained by differences in growth of per capita gross domestic product, agricultural growth and the share of the bottom 40 per cent of the population in consumption. These determinants of poverty are directly under the purview of the states, in terms of policy or government expenditure or both. There are also aspects of Central Government policies (e.g. labour) that impede aggregate economic growth or poverty reduction. However, each state has the option of adjusting its own rules and procedures to minimize the negative effects of these Central policies as well as to improve the impact of policies that come directly under its purview. States that have done so have been more successful in accelerating growth during the 1990s, while others have seen little acceleration. Performance of some states has even declined because of worsening governance and deteriorating investment climate in the state. The paper concludes that the most critical areas distinguishing state growth performance have been modern (registered) manufacturing and commerce captured best by the National Accounts sector of “Trade, Hotels and Restaurants.” To multiply the benefits of these two growth drivers, there is a need for a positive policy environment for the development of trade, hotels, restaurants, construction, real estate and townships. There is also a need for focusing on urban/civic planning and physical connectivity. The paper recommends that to eliminate poverty, economic policy should focus on, (a) accelerating growth, (b) programmes for agriculture and rural development and building roads (state, district and local) in the poorer states, and (c) target subsidies at the bottom 40 per cent of the population.

Source : Arvind Virmani, Economic and Political Weekly, Vol. XLIII, No 2, January 12, 2008, page 54-62.

Short- to medium-term prospects

2.35 There are early signs of recovery in the global economy that are manifested in rising stock prices, particularly among the major emerging economies, and increasing price of commodities including crude oil. It is however debatable whether rising prices are an indication of green shoots of recovery or a result of position taking by financial investors, seeking to benefit from global recovery expectations due to large fiscal and monetary stimulus and/or to hedge against inflation risk in the United States due to massive quantitative easing.

2.36 There are nevertheless some inconclusive indications that financial investors have been at play, as oil prices have risen sharply, despite build-up of inventories and forecasts of lower global demand. Other commodities have been no exception. Aluminium prices, for example, have risen sharply in recent months despite build-up of large inventories and the fact that the sectors using aluminium – construction and manufacturing – are more severely affected by the crisis. The speed of rise in commodity prices, as was the rapid decline last year, is another pointer to the possible role of financial investors. The fear is that the rise in key commodity prices, including oil, may adversely affect prospects of global recovery at a nascent stage. The risk is more in the case of oil, since rise in crude prices would strain the balance of payments of a large number of oil importing emerging economies.

2.37 Though the financial crisis and the transmission of its impact on the real economy is now better understood and global financial conditions have shown improvement over the recent months, uncertainties related to the revival of the global economy remain. That makes it difficult to forecast the short- to medium-term growth prospects of the Indian economy. However, a review of the strengths and some concerns of the economy is helpful in making an overall assessment.

2.38 Compared to other emerging economies, India has several strengths that can help an early mitigation of the adverse effects of the global financial crisis and the recession in major OECD economies. To begin with, India has a relatively high share of services in GDP than many other emerging economies and developing countries. Historically, across countries, services tend to be less affected by cyclical downturns than manufacturing. This factor has operated in the second half of 2008-09 and is likely to continue in 2009-10. Secondly, six years of average 4.4 per cent agriculture growth together with scaling up of rural development programmes, including the National Rural Employment Guarantee Scheme (NREGS), during the past year has kept the rural income and consumption strong. This is reflected in the momentum in rural prices (CPI for agricultural/rural labour) and the rise in WPI food inflation despite favourable agriculture growth. Thirdly, like other high-growth Asian economies, India's domestic saving rate remains high and has risen sharply with higher growth during the last five years. In fact the increase in the gross domestic saving over the last five years was greater than the increase in gross domestic capital formation over the same period (2007-08/2002-03). Fourthly, the ambitious programme of infrastructure investment designed for the Eleventh Five Year Plan period, which has now been front-loaded as a part of the policy response to the growth slowdown, provides the basis for offsetting some decline in corporate investment in manufacturing by increased investment in infrastructure by government and by the private sector through the public-private partnership model. This, however, requires greater urgency in removing the policy and institutional hurdles to investment by private sector as well as government agencies.

2.39 Fifthly, India continues to retain its position as a preferred destination for investments. In a recent UNCTAD study on assessing the impact of the current financial and economic crisis on global flows, it was found that India achieved a growth of 85.1 per cent in foreign direct investment flows in 2008, the highest increase across all countries. According to this study, FDI investments into India went up from US$ 25.1 billion in 2007 to US$ 46.5 billion in 2008 even as global flows declined from US$ 1.9 trillion to US$ 1.7 trillion during the period. Sixthly, the steep decline in commodity prices in the second half of 2008-09 along with the likely slack in global demand for at least the next 12 months would not only help in cutting down the import bill, but also have a favourable impact in effecting a reduction in below the line deficit to less than the level in 2008-09. The reduction in oil and fertilizer subsidies would help bring the Central fiscal deficit back towards the long-term trend. Finally, over the past five years of growth net exports were a depressant on domestic demand contributing (-)17 per cent to the total increase in demand over the five years. The previous five years were perhaps the only such period when net exports made a substantial positive contribution to domestic demand. The former was primarily due to high oil prices and the latter due to exceptionally low oil prices complemented by significant export growth.

The decline in oil prices in the depressed post-September 2008 global markets, complemented by other commodity prices, may partly offset the sharp deceleration in export growth. The net contribution of exports is likely to be non-negative, which is a substantial improvement over the negative contribution in the recent years.

2.40 A major concern at this stage, though not entirely unexpected, is the sharp dip in the growth rate of private consumption. Four factors seem to have contributed to this slowdown. First, it could be due to the wealth effect, resulting from a decline in the equity/property prices. Secondly, the uncertainty in the labour market and some decline in employment in India's tradable sectors may have moderated the growth in consumption expenditure. Thirdly, cutbacks in consumer credit by private banks NBFCs and other lenders, because of their limited deposit base and difficulties in secondary market financing because of the knock on effect of global financial market freezing. Fourthly, during slowdown a dominance of precautionary motive may induce consumers to either defer their spending decisions or shift to unbranded lower quality alternatives. Similarly, the slowdown in the growth rate of gross fixed capital formation (GFCF), though anticipated, is an area of policy concern from the point of an early return to the high GDP growth path. Several reasons could have contributed to this deceleration in growth of GFCF. First, surge in domestic inflation in Q1 and Q2 of calendar year 2008 reinforced the tightening of monetary policy, a trend that was already underway. It affected the cost and availability of funds for investment. Secondly, since inflation was largely on account of metals and fuels (or intermediates and basic goods), bulk of it was absorbed by industry, which affected its internal accruals and profitability, reducing to that extent the investible funds. Thirdly, despite monetary policy becoming accommodative in Q3 and Q4, decline in interest rates were not up to the industry expectations. Though, nominal rates eased by 100-150 basis points real rates continued to be high. Moreover, the expectation that there could be further cuts in policy rates and in lending rates may have resulted in investment decisions being deferred.

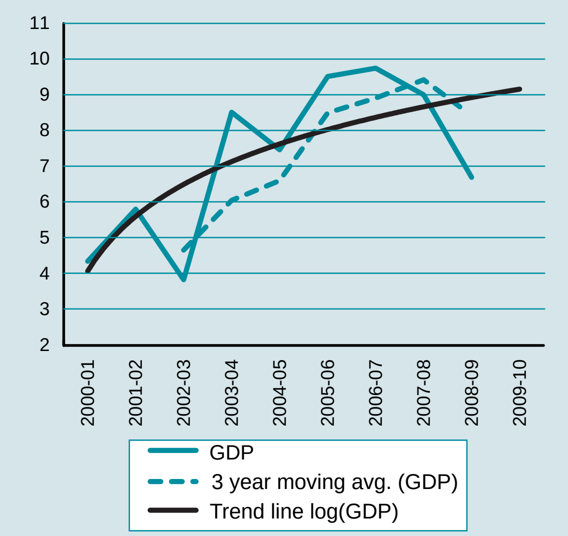
2.41 There are also certain downside risks for the Indian economy in the post-September 2008 global environment. First of all, equity disinvestment and repatriation have reduced availability of risk capital for the corporate sector worldwide. Secondly, medium- to long-term capital flows are likely to be lower as long as the de-leveraging process continues in the US economy. Thirdly, a delayed revival of the OECD economies will have a negative effect on their imports and consequently on exports of emerging economies. In fact, specific export intensive manufacturing sectors (e.g. gems & jewellery, leather products and garments) could remain affected for some more time.

2.42 The prospects of Indian economy are somewhat different from most other countries. In the first place, Indian economy has slowed and has not shrunk unlike most OECD and many emerging economies. A large domestic market, resilient banking system and a policy of gradual liberalization of capital account have been a key factor. A number of forecasts and projections have been made on the prospects of the Indian economy in 2009-10. These range from a low of 4.8 per cent (ICRIER, March 2009) to a high of 6.5 to 7.5 per cent (ICRA, April 2009). The RBI's April 2009 projection stands at 6 per cent and that of PM's Economic Advisory Council at 7-7.5 per cent. Among the international agencies, the March 2009 ADB forecast for 2009-10 is 6.5 per cent, IMF is 5.6 per cent and World Bank's forecast for the calendar year 2009 is 4 per cent.

2.43 The speed at which the Indian economy returns to the high growth path in the short-term depends on the revival of the global economy, particularly the US economy, and the Government's capacity to push some critical policy reforms in the coming months. If the US economy bottoms out by September 2009, there could be good possibility for the Indian economy repeating its 2008-09 performance, i.e. around 7.0 +/- 0.5 per cent in the fiscal 2009-10 (assuming a normal monsoon). The pattern of fiscal 2008-09 may be repeated in that case, though in an inverse sequence, with two not so good quarters followed by two good quarters making a 'U'-shaped revival of the growth path. However, in the event of a more prolonged external economic downturn, with revival of the global economy/US economy being delayed until early 2010, the growth may moderate to the lower end of the range.

2.44 This recovery is likely to be assisted by the likely developments in the external sector. The declining trend in trade deficit suggests that with reasonable invisible account surplus, which has been an attribute of the Indian economy for the last several years, economy may end up with a current account surplus of 0.3-2.8 per cent of GDP in 2009-10. The preliminary findings are based on the assumption of monthly trade deficit of US$ 4-6 billion in 2009-10

Figure 2.9 : GDP growth and trend



and an alternative scenario of crude basket price of US$ 70-80 per barrel to stress test the results. Further, with positive foreign institutional investment inflows and expectation of general recovery, capital account is likely to generate a surplus in 2009-10, a phenomenon that has characterized the Indian economy for the last several years. The global crisis has therefore created a situation where the economy could possibly experience both current and capital account surplus for the first time since 2003-04.

2.45 In the medium-term, with the global economy recovering from the current slowdown and given the growth dynamics of the economy in the recent years, India should be back on the new trend growth path of 8.5 to 9 per cent per annum (Figure 2.9), provided the critical policy and institutional bottlenecks are removed. It is therefore imperative that the government revisit the agenda for pending economic reforms in the first instance, with a view to renew the growth momentum.