

South Asia

Mar 3, 2010

India's growth goal a tall order

By Kunal Kumar Kundu

BANGALORE - India's goal of achieving 7.2% economic growth in the fiscal year that ends this month could be a hard stretch, after third-quarter growth came in at only 6%, according to figures released last Friday, coinciding with the announcement of the government's annual budget. Hitting the 12-month target would now require an 8.8% surge in the fourth quarter.

The expansion of gross domestic product (GDP) in the three months to December showed a drop from the 7.92% growth in the second quarter and it was below the 6.15% achieved in the three months to last June. My own forecast for this fiscal year is a maximum of 7%, with fourth-quarter growth closer to about 8%.

Fourth-quarter industry growth should be higher (given the lower base effect as industry hardly grew during the same period last year), and agriculture growth will remain subdued, again due to the base effect as year-earlier agriculture growth was quite high at 3.26%, the highest recorded during the past eight quarters.

On the positive side, domestic demand is picking up, aided by government stimulus measures and lower core inflation, although food inflation has been running up in a fashion that would give many Latin American economies a run for their money. This has been aided by lower interest rates.

Rising demand has also been fueled by purchases being brought forward as consumers become convinced that a government exit from various stimulus measures (mainly duty roll backs) is around the corner. This has resulted in a rise in the Index of Industrial Production (IIP), although one is not convinced there is enough demand to justify the spurt in production.

That domestic demand has been stimulus-driven is also clear from the IIP numbers released last month. While demand for consumer durables jumped by 24.4% during the April to December period, demand for consumer non-durables remained more or less flat, up a mere 1.5%.

Consumer durables are the major beneficiaries of various tax cuts rolled out as part of the government's stimulus package. Demand in this sector has also been bolstered by spending in the social sector, thanks to windfall gains received by government employees on account of a pay revision.

With partial roll-backs announced during February's union budget and the positive effect of government spending slowly waning, it is unlikely that domestic demand will continue to rise to the extent that would support high growth. I believe the present stimulus-driven growth rate will actually lead to a reduction of a few basis points from next year's growth.

All the same, even a 7% (or a little less) GDP growth rate is still fantastic, especially given the global economic conditions. With the US economy not yet out of the woods and now Europe being a potential candidate for a double-dip recession, triggered by the debilitating impact of the sovereign debt crisis in Greece, India has definitely weathered the storm well. Policymakers are again talking of a 10% growth rate. That, too me, is a tall order. In fact a very tall order.

Why so?

With the global economy unlikely to be back on track soon (even 2011 looks likely to be a difficult year), high growth in India will be crucially dependent on very high domestic demand. However, there are strong headwinds.

Inflation is one. Until the third quarter of 2009, inflation (as measured by the wholesale price index) was benign, to the extent of being even negative for some time, although food inflation by that time had touched double digits. A poor monsoon ensured that food inflation continued to be stubborn in high double digits and overall inflation started rising fast.

Even then, core inflation remained low. but now there's every possibility that core inflation will move up fast, even as food inflation will likely slow, given that the *rabi* (winter) crop has been better and also because the base effect will start to kick in. The recently announced budget will actually have an inflationary impact. A partial roll-back of stimulus through increases in excise duty, imposition of duty on petroleum, cement and other products will have a cascading effect on inflation going forward.

Also, Indian consumers, given their healthy propensity to save, are not going to act overnight like free-spending US consumers.

The most disturbing part of the economy continues to be the high deficit.

India is one of the most indebted nations among the major economies. The high level of debt compared with GDP is at 54.2%, forcing the economy into a vicious cycle in which a substantial portion of government revenue goes towards interest payments. This leaves little room for spending on developmental activities, which in turn hurts economic growth - thus forcing the government to borrow even more. In this way, the cycle continues, possibly leading to a sovereign default or hyperinflation.

Of the projected fiscal deficit of 3,814 billion rupees (US\$83 billion) during the 2009-2010 fiscal year, released in the budget document last week, the revenue deficit accounts for 2,765 billion rupees, which means that nearly 72.5% of the fiscal deficit is accounted for by revenue deficit.

This means that only a quarter of government borrowing would be used for capital investment while the remainder would go towards government housekeeping expenses. Not surprisingly, the debt service burden will continue to be a worry. The budgeted gross interest payment at 2,487 billion rupees for the coming financial year accounts for more than 65% of India's fiscal deficit. This means that the government needs to borrow a lot of money simply to meet its interest obligations.

Finance Minister Pranab Mukherjee in his budget speech committed the government to reducing the deficit (and hence the debt) to reasonable levels. But, if history is anything to go by, this is unlikely. If nominal GDP growth is high, this would lead to higher revenues, enabling the government to reduce the deficit. It seems that the government is banking on high inflation and hence high nominal GDP growth to meet its revenue target. On the other hand, high inflation will slow down demand and lead to higher interest rates and derail high-growth prospects.

It is also clear that the government is banking heavily on disinvestment proceeds (at 250 billion rupees) and the auction of broadband wireless access licenses (worth perhaps 350 billion rupees, although this was not explicitly mentioned in the budget document) to bridge the funding gap. Both these targets seem to be too optimistic, given the current global scenario and also due to waning investor appetite and heightened risk perception of the Indian telecom sector.

Add to these, numbing bureaucratic impediments, corruption-riddled delivery mechanisms (which bring to naught various social-sector initiatives), an inefficient agricultural sector and so forth, and it becomes clear why a double-digit growth rate will elude India.

Kunal Kumar Kundu, is a senior practice lead, process and domain consulting, Knowledge Services Division, Infosys Technologies Ltd. The author's website is: <http://kunalsthoughts.weebly.com>