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Why India cannot sustain high economic growth

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The high economic growth recorded over the past few years made many believe that the Indian economy has entered a high growth path. Many people opined that the high growth rate is more structural than cyclical and hence sustainable.

However, with inflation inching towards 8 per cent (actual figures could be as high as 10 per cent!) and Index of Industrial Production (IIP) barely touching 3 per cent, some doubts are creeping into the minds of investors about the resilience of the Indian economy.

The optimists, though, are pointing to the base effect phenomenon, i.e. last year inflation was low while growth was high. They feel that inflation will moderate in a few months, especially next year when the base year effect again kicks in, while the recently recorded IIP number is more of an outlier and soon a better picture will emerge.

But is it really that simple? The answer would be no. Has the Indian economy really reached a stage wherein an 8 per cent plus growth rate is a given? Hardly.

The fact is that despite the reforms, there has hardly been a fundamental improvement in the economy that would suggest that India's trend growth rate has jumped to 8.5 per cent.

Here's why:

Reforms, how much have they delivered?

For starters, let us take the oft-beaten track: India's economic performance; and comparison of average annual growth rate during the decade prior to the reforms and after that.

If numbers tell a story, it's not a pretty picture.

During the fiscal years 1980-81 to 1990-91, the average GDP growth rate was 5.38 per cent *(Source: Handbook of Statistics, RBI)*. In comparison, the average growth rate between 1990-91 and 2006-07 was 6.23 per cent, an increase of less than one percentage point.

On the other hand, reforms in China had galvanized the economy to such an extent that they had an inexplicably long run of double-digit real GDP growth rate. India has never achieved a double-digit growth rate.

The sectoral detail is even more alarming. Agricultural growth decelerated from an average of 3.39 per cent in the pre-reform period to 2.77 per cent. Even the industry didn't really do too well. The average growth rate was lower by nearly 0.57 per cent, as it decelerated from 6.72 per cent to 6.15 per cent.

The saving grace, not surprisingly, was the service sector as its average growth rate increased by more than 1.48 percentage points, from 6.33 per cent to 7.81 per cent. And the impact of reforms on the service sector was more incidental than intended. In fact, had it not been for the service sector, reforms would have earned the dubious distinction of having pulled down the economic growth of India.

Agriculture, the laggard

Let's take the agricultural sector. A sector that supports nearly 70 per cent of the country's population has seen a steady decline. A slide that even reforms failed to stem. India's agricultural productivity, in most cases, is one of the lowest in the world (Inflation -- who's to blame?). Per capita availability of food grain is falling as population is growing faster than food grain production. Deplorable rural infrastructure leads to India wasting an amount of food grain that is more than half of Australia's food grain production. India's agriculture is still so very highly monsoon dependent, et cetera.

Unfortunately, in case of agricultural produce, unlike oil, producers do not always benefit from rising price because of wrong policies and bad infrastructure. Not surprisingly, farmer-suicides are still commonplace in India. And, to top it all, investment in rural infrastructure is falling.

So what have reforms delivered to the nearly 70 per cent of India's population? Nothing!

Fiscal correction, a mirage

The country's financial position is in a mess. India's deficit is the highest among those in major emerging markets and about 2-3 times that of major developed economies as a percentage of GDP. Although there has been some improvement in the fiscal deficit trend (a greater credit for which should go to the imaginative accounting practices), there is little evidence that the government is implementing any major structural reforms to reduce revenue expenditure.

Moreover, the current high level of unproductive government expenditure and public debt are weighing on long-term growth potential. The government's spending on productive areas such as infrastructure, education, health and welfare has been constrained by high levels of non-development expenditure and a high level of debt.

The government's average annual development expenditure growth rate plummeted by more than 6 percentage points, falling from an average 15.97 per cent during 1980-81 to 1990-91 to an average of 9.75 per cent during the post-reforms period.

The fact is that the existence of revenue deficit indicates that a part of the borrowings by the government is not being used to finance public investment. When the focus is only on reducing the fiscal deficit, the brunt of fiscal correction is often borne by a reduction in capital expenditure. With the quality of fiscal correction remaining questionable, the growth potential of the Indian economy gets compromised.

Higher growth path?

This brings us to the issue of current high growth and its sustainability. Between 2002-03 and 2006-07, the Indian economy grew at an average rate of 8.6 per cent. This warmed the cockles of our hearts, particularly of the policy-makers', who started to feel that their policy actions over time have resulted in the Indian economy reaching a higher plain.

This, however, does not seem to be the case. High growth, recorded during the last few years, seems to be more cyclical in nature than structural. Strong global growth, benign inflationary situation and ample liquidity sloshing around caused by a loose monetary policy, both globally and in India, led to this strong growth. This engendered a tribe of economists that heralded the decoupling theory.

However, with the American economy slipping into recession and inflation becoming a major concern world-wide, India is on the verge of a slowdown. We are now seeing the decoupling theory giving way to the 'recoupling' theory.

India does not seem to have reached a stage where continued high growth will not trigger inflationary pressure, unlike China which sustained a scorching pace for a much longer period of time on the back of clearly improving productivity. India does not seem to have gained much by way of improving productivity that would have ensured sustained high growth. A mere five-year-long high GDP growth is seemingly choking the economy via inflation.

The sustainability of growth would also depend on high savings rate. However, a closer look at the composition of India's savings rate does seem to suggest that the recent spurt in the rate has more to do with cyclical factor than real structural improvement.

Gross domestic savings rate

Period	Savings rate
1991-92	21.5%
1992-93	21.2%
1993-94	21.9%
1994-95	24.4%
1995-96	24.4%
1996-97	22.7%
1997-98	23.8%
1998-99	22.3%
1999-00	24.8%
2000-01	23.7%
2001-02	23.5%
2002-03	26.4%
2003-04	29.8%
2004-05	31.8%
2005-06 P	34.3%
2006-07 QE	34.8%

Source: Economic Survey 2007-08

The above table shows that India's savings rate surged from 2002-03 after remaining stagnant (even experiencing a decline in certain periods) for a long time. This surge clearly coincides with high GDP growth rate. While this seems to be a positive development, a closer look at the savings data throws up some worrying facts.

Sector-wise domestic savings in Rs crore

Year	Household sector	Private corporate sector	Public sector	Gross domestic savings
1991-92	103,495	20,304	17,290	**141,089**
1992-93	123,315	19,968	16,399	**159,682**
1993-94	149,534	29,866	10,533	**189,933**
1994-95	188,790	35,260	23,412	**247,462**
1995-96	201,015	59,153	30,834	**291,002**
1996-97	220,973	62,209	29,886	**313,068**
1997-98	270,308	65,769	27,429	**363,506**
1998-99	329,760	68,856	-8,869	**389,747**
1999-00	412,516	87,234	-15,494	**484,256**
2000-01	454,853	81,062	-36,882	**499,033**
2001-02	504,165	76,908	-46,186	**534,885**
2002-03	569,134	94,772	-15,936	**647,970**
2003-04	670,776	120,730	29,521	**821,027**
2004-05	725,110	206,363	68,952	**1,000,424**
2005-06 P	866,756	268,329	92,236	**1,227,348**
2006-07 QE	985,822	322,242	133,359	**1,441,423**

Note: P = Provisional; QE = Quick Estimates | Source: Handbook of Statistics, RBI

Total savings are composed of household savings, private corporate savings and public savings. Let's have a look at household savings first.

Household savings have two components: financial savings and physical savings. The financial savings component, which accounts for a larger share of household savings, rose by close to 70 per cent between 2002-03 and 2005-06. On the other hand, physical savings rose only by about 25 per cent during the same period.

In fact, the current savings surge coincides with a massive increase in the inflow of portfolio FII investment in India's stock and debt markets, and it is possible (as had been argued by S L Shetty -- *Economic and Political Weekly, February 12, 2005*) that some of this capital may have been lodged with banks and got erroneously recorded as constituting household savings invested in financial assets.

This is indeed a possibility given the increase in contribution of the financial savings (than physical savings) in gross household savings.

A major contributor to growth in domestic savings has been a near trebling of private corporate savings. While increased corporate profitability has been instrumental in this surge, it is expected that, going forward, corporate profitability might stagnate as the corporates find it increasingly difficult to pass on the rise in cost due to intense competition and governmental caps on the price of commodities to fight inflation.

The third contributor to the savings rate is public savings and, clearly there has been a major turnaround as public dis-savings (read negative savings) have now turned into positive public savings. This has been caused by, both, a reduction in expenditure and an increase in revenue.

As mentioned earlier, the reduction in expenditure has more to do with curtailing developmental expenditure in an effort to meet the FRBM (Fiscal Responsibility and Budget Management) target, which is at the cost of future economic growth.

As for the increased revenue due to better economic performance, there are enough indications that the government has not come out of its profligate ways and hence is frittering away useful resources that might not be sustainable as the economy slows down.

The Budget announcement of waiving off of agricultural loans to the extent of Rs 60,000 crore (and now increased to Rs 71,680 crore) is a case in point. With general and state elections approaching, governments -- except under severe pressure as in 1991 -- tend to take foolish economic decisions. Parties in Karnataka promised things like free power, a complete waiver of farm debt, and other things, in order to curry political support. This largesse, of course, comes from the government's (hence, taxpayers') coffers and not from party coffers.

Our subsidies are skyrocketing and as oil prices continue their journey towards record highs every other day, the strain on the exchequer will be that much more.

With the savings rate likely to take a beating, investments that can propel growth would be impacted.

Added to these are the inherent inefficiencies within the economy. India's physical infrastructure is in perennial deficit. India's power sector continues to be plagued by deficit. India's peak deficit continues to rise and has risen to 14.8 per cent during Apr-Dec 2007.

Construction of roads is mostly behind schedule. Indian ports, despite improvement, are still way behind international standards. The average turnaround time of the major Indian ports are now about 3.6 days as compared to 10 hours in Hong Kong.

Not surprisingly, red-tapism continues to rule the roost. There is an urgent need to reform the bureaucracy. Corruption too is rampant and India figures quite high in the list of most corrupt nations. All of these add to the cost of doing business in India. Quite naturally, India ranks a dismal 120 (despite improvement) in the list of 178 countries ranked by World Bank in terms of the best places to do business.

To conclude, I do not think that India has entered a higher growth trajectory. The high growth rate over the last few years has been more cyclical, than structural, in nature. And continued supply side bottlenecks will necessarily mean that periods of high growth will trigger inflationary pressures.

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