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India's Growth Fantasy

A 10% target isn't achievable without a strong dose of liberalization.

By SWAMINATHAN S. ANKLESARIA AIYAR

Prime Minister Manmohan Singh says he want India to hit an annual GDP growth rate of 10% soon. Since the country averaged 8.5% from 2003-08, he thinks this is definitely achievable.

Think again. Given a sluggish global economy and lack of domestic reform, India may not average much more than 8% growth in the next five years. True, the country has many advantages—cheap skills, catch-up possibilities and good demographics (the working-age share of the population is rising). But against these must be weighed disadvantages such as high inflation, rising corruption and deplorable public services.

The biggest dampener is not local but global. Record financial leverage and global imbalances created the mother of all booms from 2004 to 2008, and a giant global tide lifted all boats. Sub-Saharan Africa more than doubled its growth rate to 6%, from 2.4% in the preceding two decades. This puts India's performance in perspective. Yes, its growth rate improved, but not as much as Africa's.

The Great Recession has ended, but the world will not revert to a leverage-financed boom. Europe is headed for years of slow growth or stagnation, and the U.S. recovery is hesitant. And India is more integrated with the world economy than ever before.

Exports, including service exports, have risen to over 20% of GDP from 7.2% in 1990. Computer software and business services exports grew at 40% per year in the 2004-08 boom, while merchandise exports grew at 20% to 30% per year, sometimes twice as fast as nominal GDP. Hence export growth pulled up GDP growth. This will not happen to the same extent, if at all, in coming years, since the global trade outlook is sombre.

Recovery from the recession will boost exports this year, but in the longer term prospects are less promising. Exports of software and business services slowed to 5% last year, and are projected to grow just 13% to 15% in 2010-11.

Government economists overestimate the extent to which India can accelerate if export growth slows. One major reason for their optimism is that India's savings rate shot up to about 35% in recent years from 23% in the 1990s. Supplementing these savings with modest capital flows from abroad, India can invest 40% of GDP per year. Assuming a capital-output ratio of four to one—which was achieved in the boom period—40% investment will translate into 10% output growth.

This calculation is neat, plausible and wrong. Higher investment does not guarantee higher output. The Soviet Union collapsed when output refused to grow with higher investment. Even the East Asian tigers suffered diminishing returns as they invested more and more. In all of history, only China has sustained 10%

growth over a period of decades.

Indian reforms to improve productivity could be new sources of growth. But the government is focused on welfare spending, such as subsidized food and rural employment schemes, rather than economic or administrative reforms. India stands a pathetic 133rd out of 183 countries in ease of doing business, according to the World Bank's "Doing Business 2010." It comes 169th in ease of starting a business, 175th in giving construction permits and 182nd in enforcement of contracts. Legal delays are horrendous: It took 25 years to complete the supposedly top-priority case against Union Carbide officials for the Bhopal gas disaster of 1984.

Transparency International ranks India a lowly 84th in its Corruption Perception Index. The quality of public services, especially education and health, is terrible: India ranks 134th in the UNDP Human Development Index.

Privatization remains a dirty word. The government refuses to reform labor laws that make it impossible to sack workers, discouraging Indian companies from challenging China and Vietnam in labor-intensive sectors. As a result, Bangladesh has overtaken India in garment exports. Financial-sector reforms remain on ice. Price controls on petroleum products have been partially eased, reducing huge consumer subsidies, but if global prices shoot up, price controls will almost certainly return.

Despite such shortcomings, India averaged 8.5% growth in the five prerecession years, and achieved 6.7% even in 2008-09, the worst recession year. It improved to 7.4% in 2009-10, and may exceed 8 % this year. Optimists may seem justified in arguing that India will do better in coming years.

Yet this is hardly inevitable. Domestic inflation is exceptionally high and the rupee is appreciating. Indian wholesale price inflation today is 10% and consumer price inflation 14%. Higher interest rates to cool inflation are inevitable, and will dent growth.

After a recession, the world economy typically recovers sharply, and then grows at a more sedate pace. So, India's 8% to 8.5% growth this year may reflect the sharp recovery phase, followed by a more sedate pace. Mr. Singh's target of 10% growth would be feasible if he went for economic and administrative reforms in a big way. That remains a big if.

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