

The Growth Institute: Briefing

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India's economic growth prospects: Have we turned a corner?

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Background

The Indian economy has exceeded government estimates by notching up 6.7 percent growth for FY09. However, it is unclear whether this is part of a trend or simply a blip on the radar. Gloomy economic statistics from Europe, America and Japan, combined with mixed signals from the domestic economy have made it difficult to predict what lies ahead.

To shed some light on what may be in store in these challenging times, The Growth Institute, 9.9 Media hosted a session on "India's economic growth prospects: Have we turned a corner?" on 30th May 2009 at The Imperial Hotel, New Delhi. The session was addressed by Mr. Mohit Satyanand, Consulting Editor with Outlook Money. A management consultant turned entrepreneur, he has interests in education, food processing and the performing arts. A trained economist and self-proclaimed "rabid free marketer", Mr. Satyanand shared his perspectives on the state of the economy and offered some interesting insights on what may lie ahead.

The critical conundrum

The government of India is faced with the most critical conundrum today. The Finance Minister, Mr. Pranab Mukherjee has to balance the difficult task of reducing interest rates while increasing spending on social sectors. This dichotomy is faced not only by India but by all countries. This has led to a larger role for governments in the economy and a growing closeness between the treasury and the central bank. Such proximity might not be healthy for the economy as it would make the government control fiscal and monetary policies, whereas the latter should be the exclusive preserve of the central bank.

It is too early to make a definitive prediction about Indian economy being on the path to recovery. The perceptions of what growth actually means have themselves changed in India in the past one year. Today, observers hail 6% as a high growth rate. But they would have been decried for being 'pessimistic' if they mentioned this rate in the first half of 2008!

Sentiments play a key role in influencing the direction of the economy. While indices are an indicator of sentiments, they may sometimes reveal two contrasting perspectives, making forecasting difficult. For instance, while the Consumer Confidence Index in the United States went up by 16 points on May 29th, the ISM manufacturing index fell by 14 points on the same day! Thus, it is difficult to choose which news to believe and then take the right decisions. Research in behavioural economics also indicates a strong relationship between market levels and consumer expectations. As markets rise, consumers automatically have a more positive outlook towards the economy. These sentiments help drive higher growth. It is this 'confidence game' that has partly transformed India from being a 5 to 6 percent growth economy to a 10 percent growth economy.

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Managing fiscal deficits

In addition, this extra growth might also be attributed to the worldwide investment boom, made possible via the availability of cheap credit after the dotcom bust. This investment boom was enabled to avoid a bust, but also gave rise to inflation, a natural consequence of money supply exceeding the economy's capacity to absorb it. This cycle got repeated as consumers began to buy assets (such as homes), leading to an asset price bubble. To avoid pricking this bubble, the US government effectively printed more money and raised its fiscal deficit. Simply printing money to manage the fiscal deficit is unsustainable, and this was another factor that caused the current financial crisis in America.

Similarly, in India, the past few years have seen a juggling of the books with oil bonds and subsidies being classified as "off-balance-sheet liabilities", simply to make the fiscal deficit numbers look more presentable. Additionally, programmes like the NREGA, the farm loan waiver, the Sixth Pay Commission awards etc. have added to the fiscal deficit. We have to be cautious about the unpredictability of sitting on this 'inflation balloon'. Two questions need our immediate attention: How long can the government continue to increase its expenditures without improving its tax collections? And if the government does increase tax rates, how would that impact the 'animal spirits' that drive current investments?

It is evident that the situation around foreign exchange risk is too complex. The unprecedented volatility of the rupee has made it difficult to predict its movement. Therefore, gold seems to be a safer asset to hold, rather than any particular currency. While the US dollar was expected to depreciate due to the banking crisis in America, the dollar actually appreciated for a short while due to banks liquidating many of their assets. As an example, if a bank sold its assets in India, it would obtain rupees for the sale and would then convert those rupees into dollars to send it back to the United States. Hence, dollar demand went up due to the sudden sales of US banking assets.

"...look at the Indian economy – 60-70% of it is in health, infrastructure, food and education – it is so underserved that I don't see any other way for the domestic consumption to go, than just go up."

Would inflation benefit holders of assets in emerging markets?

There is a fine distinction between speculative assets and productive assets. Foreign investors with large piles of cash would prefer to invest in commodity assets (such as copper in Brazil, or gold in Australia) rather than in speculative assets (such as real estate in Greater NOIDA). Commodity assets would yield returns as they are involved in manufacturing, or other productive activities that add economic value. However, speculating on real estate is more of a punter's game, providing little value.

Comment on the nature of government spending on education and its impact...

Due to a raging debate over whether education, for instance, can be classified as a public or private good, very little has been achieved in this arena. If the government were to simply allow more open and private participation in the education sector, a lot more could be achieved.

On the relative importance of the agriculture, manufacturing and services sectors to the Indian economy...

Unfortunately, agriculture is the worst off although its potential is very high. There is little movement on agriculture reform, as the model agriculture bill, which has been tabled for 5-7 years, has got the support of only three states (agriculture is a state subject in India).

The fundamental reform is necessary for the economy and country to move forward. For instance, the issue of land ownership that poses more problems for economic development than almost any other issue. While the colonial system would constitute land settlement policies every 20 or 30 years, ensuring that ownership and property rights were clear and enforceable, current practices have meant that landholdings are getting smaller. This makes the land uneconomical to farm and grow produce. There is a lack of will to take on the vested interests that thrive in this current system. Unless these are removed and land can be consolidated to be economically viable, the growth prospects for India will remain less than optimal.

“The consensus now is that the recovery is on. But i haven’t bought a fully paid ticket to this consensus and my vote is still out.”

Conclusion

Has the Indian economy had indeed ‘turned a corner’? It is still difficult to reach an answer for this question. The current rally would not last long and that the economy is headed for difficult times. Unless the government undertakes radical reform, like allowing for free movement of agricultural goods within the economy and controlling the fiscal deficit, the economy is unlikely to see growth of 9-10% in the long term.