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India's Potential Growth: A Reality Check

RBI's first quarter review of monetary policy surprised the markets. The market expectations were of 25 bps increase and some even expected RBI to pause given successive rate hikes since Mar-2010. People also felt RBI's policy statement would be dovish and hint that rate tightening cycle is more or less over. These expectations set in market euphoria and people were looking at yields trending lower tracking the expected RBI's dovish stance.

However, the policy outcome was a lot different with RBI raising the policy rates by 50 bps. The statement was seen as highly hawkish on inflation with no sign of any rate pause. In its forward guidance RBI clearly says that change in policy stance *"will be motivated by signs of a sustainable downturn in inflation."* Both the policy outcome and forward guidance have reversed the market sentiment with people now discussing how many more rate increases are likely to come. The persistent rate hikes has again bought the discussion of inflation vs. growth rate to the fore. Experts are divided on which matters more - inflation or growth.

This paper asks a very different question related to India's potential growth rate. It is widely assumed that India's potential growth is a given at 8-9%. This paper questions this assumption given the current global turmoil and lack of economic reforms. There is a need to be more realistic on the potential growth rate targets for Indian economy.

I. Background

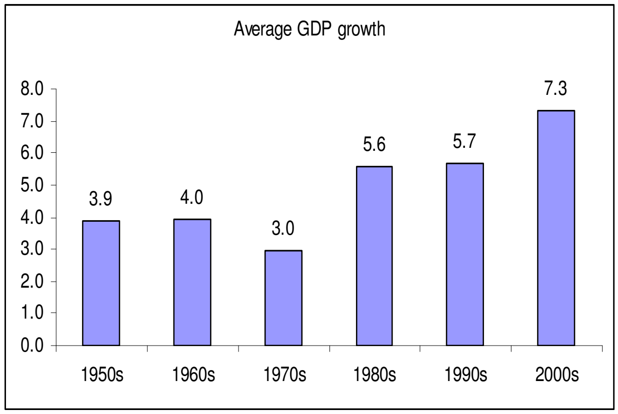
One major concern which people voiced before and after the monetary policy is slowdown in India's growth. There is a wide belief that India's potential growth rate is 8-9% and anything lower than that is below par performance. With multiple rate increases, experts feel growth rate is going to be impacted and growth forecasts for 2011-12 have been lowered to below 8%. They further argue that lower growth rate is not acceptable for India as it is a poor country and needs to grow at potential to realize the gains fully.

Growing at potential also implies standards of living improve in lesser number of years because of the compounding principle. For instance if India grows by 7% for next twenty years, its total GDP in 2029-30 will increase by 3.6 times of 2010-11 GDP. The same analysis for 9% growth shows GDP growing by 5.1 times. Then high growth rates also have other important implications. They lead to higher taxation revenues, higher investments and set in a virtuous circle.

II. India's Potential GDP Growth

Indian economy clearly picked up in 2000s with average growth rate in 2000s rising to 7.3% from 5.7% in 1990s and around 4.4% from 1950-2000 (Figure 1). The average growth rate since 2003 is even more impressive at 8.5%.

Figure 1



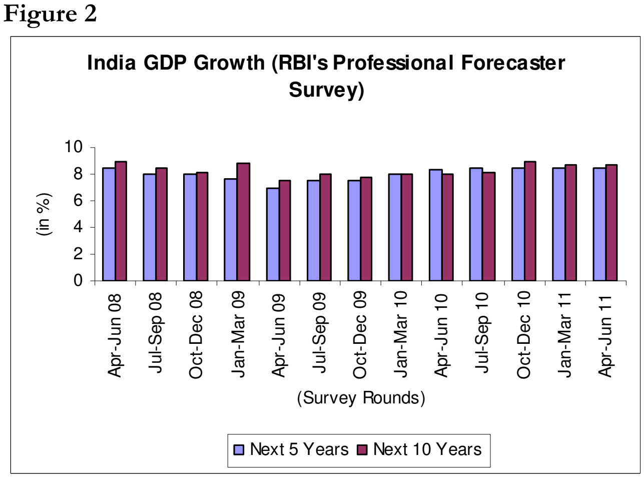
Source: RBI

This average growth rate since 2003 is now being projected as India's potential growth rate. The Planning Commission in its Twelfth Five-Year Plan aims to raise average growth rate in the plan to 9-9.5% from the target of 8.2% in Eleventh Plan. Planning Commission in a recent Twelfth Plan Meeting said – "A key issue is what the Growth target should be. The target of 10% is being mentioned, but our internal assessment is that even 9% will be difficult given the constraints we face." A similar target of potential growth comes from Finance Ministry and other official bodies. So much so, growth lower than 8% is deemed as slowdown in Indian economy.

It is ironical how quickly this sentiment has changed. Even till 2005, few expected India could grow at even around 8% for the next few years having grown on an average of 8.5% between 2003-05. And now, most forecasts indicate India growing at 8% plus for the next 5-10 years.

RBI's Survey of Professional Forecasters shows that median growth rate for next 5 years is around 8.5% and even higher at around 8.7% for next 10 years. Only during global recession, the forecasts were lower at around 7-7.5% for next 5 years and around 8% for next 10 years. So, even during the global recession people expected some decline in next five years followed by a higher rise in the next 10 years. As recession receded, both 5-year and 10-year outlooks have been revised upwards to around 8.5% and 8.7%. Hence, looking at these figures we do see that 8.5% is seen as a potential growth rate for the Indian economy over a long term.

Figure 2



Source: RBI

Hiroro Oura of IMF in a paper (Wild or Tamed? India's Potential Growth, 2007) summarized the results of some research papers calculating India's potential growth. The papers used different methodologies and hence the differences in potential growth rates with range varying from a low of 7.3-7.6% to a high of 9.5-9.8%. The author says, excluding two studies with more extreme human capital assumptions potential growth rate could be around 8-9%. It needs to be pointed out that all these papers were written in phase of Great Moderation when world economy was growing at a fast pace and there were no real economic concerns. The economic situation is drastically different from the pre-crisis phase.

Table 1: Estimates of India's potential growth (in %)

	Rodrik-Subramanian	Poddar-Yi	WEO	Bosworth Collins
Paper written in	2004	2007	2006	2006
India's Long Term GDP Growth	7.3-7.6	9.5-9.8	8.7-9.0	8.0-8.4

Source: Oura (2007)

III. Reality Check on Potential GDP Growth

Economic forecasts change dramatically in a short time tracking the real time economic situation. Like we see in RBI's survey how even the long term growth forecasts were revised lower in times of global recession. The best example of how quickly forecasts are revised is with respect to the US economy. In the last years of Bill Clinton's Presidency, the US had budget surpluses showing how US federal government has been fiscally responsible. All the agencies including CBO forecasted budget surpluses for an extended period of time. And then the whole outlook changed in President Bush and Obama's tenure with US budget situation in huge stress. The government is now deemed as very irresponsible and most agencies projecting extended periods of budget deficits.

The same could be true for India as well. Potential growth implies using all the economy's resources optimally. Here there are both the aspects – boosting the economy's resources based on supply side economics and then using the resources optimally based on demand side economics. Many economists and reports have shown how India's growth so far has been mostly about rising demand with little subsequent rise in supply. Supply side deficit hurts the economy severely as augmenting supplies take a long time and there has to be a vision to scale the supplies in line with growing demand few years ahead. If there is miscalculation with respect to rise in demand it leads to many problems like overheating economy, rising asset prices etc.

The research on Indian reforms shows that growth in 2003-08 was basically on account of some supplies created due to reforms in 1991. These supplies were utilized optimally in the period of high growth accompanied by low inflation & oil prices and robust global growth. Another very strong factor was lower fiscal deficits which led to lower interest rates and inflation as well.

In current economic environment, all three factors are not in favor. The several cases on governance deficit have added further problems for Indian economy.

- **Persistent inflation:** Inflation is itself a result of persistent deficiency in supply side reforms and agriculture productivity. The high inflation has led RBI to increase policy rates by 275 bps since Mar-2010 and still there is no relief in sight. The inconsistent policies of trying to raise rural incomes via various social development programs without any major effort to augment food resources has led to persistent food inflation. The high food and fuel inflation (because of global prices) has led to a more generalised inflation with steep rises seen in prices of manufactured products as well.

The central bank has acted on this rising inflation by raising policy rates by 325 bps since Mar-10. These higher rates are now impinging on growth rate of investments which leads to both lower growth and higher inflation as without investments the problem of supply shortages gets exacerbated. It is for these reasons inflation is always seen as a thorn for policymakers. It is one variable but impacts economies adversely in multiple ways. Once it starts rising and gets entrenched in expectations, it is very difficult to lower it. This is an experience shared by many of world's policymakers and is now being faced by India's policymakers as well.

- **Fiscal Deficits:** The rise in fiscal deficit is another major worry for India. The fiscal deficit for FY 2011-12 is pegged at 4.6% of GDP which is already being questioned amidst rising oil and food prices. Decline in investment climate has led to decline in tax and non-tax revenues as well. Both RBI and PM's Economic Advisory Council has said meeting these fiscal targets would be challenging. Market economists have already revised their fiscal deficit estimates and peg it around 5.2-5.5%. This is further putting pressure on interest rates and inflation. Another serious issue is underreporting of fiscal deficits as seen before the crisis. Earlier fiscal deficit was reported lower as special bonds (oil, food and fertilizer) issued by the government was not included in government balance sheet. Now, overall subsidies (especially oil) are being projected lower than most analysts' expectations and also does not justify the global pricing trends of oil and food.

- **Governance:** There have been serious reported concerns on the quality of governance and policy reforms in the country to improve the investment climate. Governance in India has always been a source of concern but was ignored in most economic analysis. But it is now acting as a major impediment for further reforms in the economy. This perplexed situation of poor conditions in supply side economics have been highlighted in one report after the other but nothing significant has been done. Prime Minister's Economic Advisory Council in each of its outlook reports mentions the deficits in infrastructure and particularly in power sector. Same is the case with Planning Commission and numerous other committees. This is having some serious ramifications on Indian economy with glaring deficiencies in major sectors. Experts suggest India should move into the second generation of reforms (labor sector, reforming institutions etc) where much of the work in first generation reforms is still incomplete.

- **Global economic situation:** It is again entering a soft patch after showing signs of improvement from 2010 onwards. Some economists opine that probability of a double dip recession is higher than ever before. US GDP data showed that economy has grown much slower than expected. Since the end of recession, GDP in last eight quarters has grown at 2.5% making it one of the weakest recovery phases. The political brouhaha over US debt limit has shown how politicized the whole economic process has become. S&PD downgrading of US long term sovereign credit rating has been downgraded from AAA+ to AA+. This has been another of many unprecedented events in economics from 2007 onwards.

  Similarly political and economic concerns over Europe have led to sobering of the world growth outlook. ECB resumed its liquidity facility started during the crisis and is even reported to buying bonds of troubled economies. There is little clarity on how the European debt crisis would be resolved. The crisis has moved from peripheral small economies of Greece and Ireland to larger and core economies of Spain and Italy. Amidst all this, ECB remains the only major central bank to increase its policy rates making it even costlier for troubled economies to raise resources.

Given this overall economic environment, it is difficult to imagine India can continue to grow at 8-9%. Even before the crisis similar optimism was mentioned that Indian economy is decoupled from global economic developments and can grow despite global crisis. This statement proved wrong post

Lehman leading to sharp volatility in financial markets, drying up of foreign institutional investment and decline in external trade. The sharp downfall and fears led government to pass fiscal stimulus leading to doubling of fiscal deficit. The fiscal situation has remained under stress since then as India is again back to running large deficits and at levels seen during 1991 crisis.

The same optimism is being shared now. The decoupling hypothesis stood false in 2008 as well and is expected to be false once again. The lack of reforms and persistent inflation has already led many private sector economists lowering the growth for 2011-12 at 7.2% - 7.5% from a high of 9% forecasted in Dec-10.

IV. India's Long Term Outlook

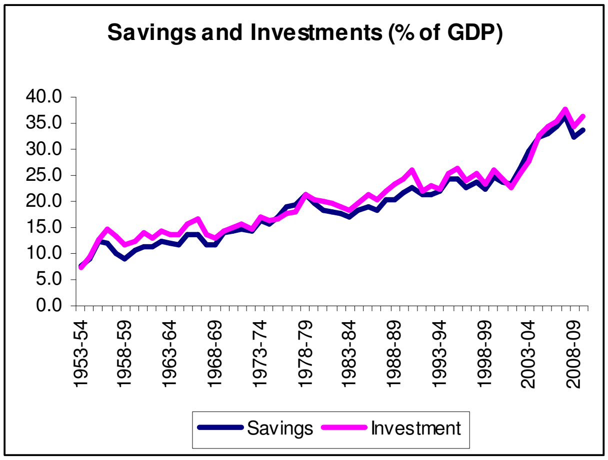
Barring the short term outlook, one needs to look at long term growth prospects as well. Few leading Governments and World Bank set up a Growth Commission to understand the drivers for sustainable growth. The committee said post World War II thirteen economies had managed to grow at a sustained growth of 7% for twenty-five continuous years (Botswana, Brazil, China, Hong Kong, China, Indonesia, Japan, the Republic of Korea, Malaysia, Malta, Oman, Singapore, Taiwan, China and Thailand). These economies had five common parameters:

1. Exploited the world economy: These economies imported ideas, technologies and best practices from world economy and some even tailored them to suit their own economy. Then they also actively exported to global economies allowing their domestic firms to compete. This combination of importing and exporting helped these economies share and become a part of global economy.
2. Maintained macroeconomic stability: This point is obvious given the importance of stability in any economy. The report points that during their sustained growth period, these economies avoided economic turbulence. Some economies like Korea and China had high inflation in some of the years but it did not deter investors from investing in these economies. Governments were fiscally responsible in most of these glory years with budget deficits mostly in limits.
3. Mustered high rates of saving and investment: In the mid-1970s, Southeast Asia and Latin America had similar savings rates. Twenty years later, the Asian rate was about 20 percentage points higher. This saving has been accompanied by prodigious rates of domestic investment leading to growth and prosperity.
4. Allocation of resources by markets : The high-growth economies relied on a functioning market system, which provided price signals and provided incentives to supply whatever was in demand. There was emphasis on decentralized decision making with a continuous effort to improve investment climate.
5. Committed, credible, and capable governments: The high-growth economies typically built their prosperity on sturdy political foundations. Policymakers and governments were committed to the cause of high growth in their economies and ensuring an environment that fosters all the above four factors for growth continuously.

On a quick comparison with India, we can say barring third parameter there are many pending issues in all other parameters. Savings have increased sharply in last decade on account of surge in household and private sector savings. Because of fiscal prudence adopted by government, even public sector savings were in surplus. The high savings led to spectacular rise in investments (Figure 3) fuelling the overall GDP growth to 8.5-9%. The savings declined in 2008-09 mainly because of decline in government savings which declined because of rise in fiscal deficits because of the crisis.

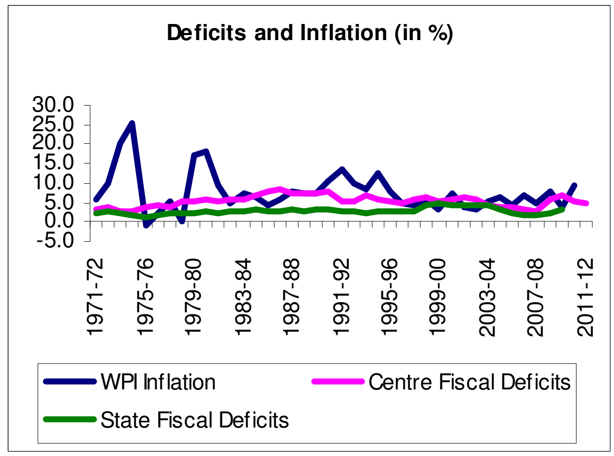
In terms of macroeconomic stability, we can again see both inflation and fiscal deficits declining during 2003-08 leading to 8% plus growth. It was one of the major factors aiding in rise of India's growth story. However, both inflation and fiscal deficits are a source of concern now. India can take some hope from experiences of China and Korea where also inflation rose in spurts and then eased because of policy measures. India should avoid statements like new normal for inflation where high growth rate implies high inflation and we need to tolerate inflation to grow. The experience with respect to inflation and growth is common across the world which is higher inflation only leads to lower growth and many other related problems.

Figure 3



Source: RBI

Figure 4



Source: RBI

As far as first factor is concerned, there have been some significant gains with Indian companies investing aggressively abroad and using best practices from world. Some Indian companies particularly in IT industry have actually become global benchmarks for others to follow. However, in terms of overall trade and investment flows, India still forms a very small share of world aggregates.

In the fourth point of market allocation of resources, India is placed well behind. World Bank's Doing Business report ranks India at 134 in a list of 183 economies. Within doing business, in enforcing contracts India is ranked 182 (second last), in starting business ranked 165 and in paying taxes ranked 164. Only in area of getting credit and protecting investors the rankings are better placed. This point to two things - one, how low India is ranked on various business parameters. Two, despite such poor parameters India has managed to grow at 8-9% and one can just imagine the growth rate if the various government controls are eased. All these business controls also form part of first generation of reforms which are far from completion.

Table 2: Doing Business Rankings-2011

	Rankings
Ease of Doing Business Rank	134
Starting a Business	165
Dealing with Construction Permits	177
Registering Property	94
Getting Credit	32
Protecting Investors	44
Paying Taxes	164
Trading Across Borders	100

Enforcing Contracts	182
Closing a Business	134
Source: World Bank	

The last factor of strong leadership has been discussed in state of governance in India above. As seen in the thirteen economies, this one factor could easily derail all the four factors. This has been the experience of Latin American and African economies that do not grow despite being endowed with significant share of natural resources. Instead it becomes a natural curse as political forces just exploit these resources with huge wastage and corruption. There is an urgent need to look at this issue with respect to India.

India is also a curious case of highlighting its growth achievements with just 5-6 years of rapid growth. The other cases of high growth economies like South East Asian and Chinese economies came after nearly two decades of growth. The approach so far of just mentioning the growth number without really focusing on its various drivers will only result in disappointments.

V. Concluding Thoughts

This analysis does not suggest that India's potential growth is lower. It attempts to highlight that given current economic and political situation, India is well short of achieving its true potential. The uncertain outlook on global economy is also likely to weigh on India's growth outlook. The policymakers take 8-9% plus growth for granted without moving forward on supply side reforms. In terms of long term potential, India is critically placed amidst hope and realization. There is a long list of pending reforms which have not been addressed for so many years. India' liberalization strategy has so far been based on picking low hanging fruits like opening up markets for consumption items, developing equity markets etc. The high hanging fruits of building robust infrastructure and improvements in social indicators continued to be distant from global average.

Based on above analysis, it might just be better for economists and policymakers to do a reality check of the economic situation and scale the growth prospects. This assumption that India can grow at pre-crisis growth levels of 9% and above despite all these major hindrances (high & persistent inflation and fiscal deficits, poor quality of governance and uncertain global economy) is too simplistic and naïve like most assumptions in economics.

A related point and an important one is not to treat growth lower than 8% as slowdown. Given the scale of problems and hindrances, even if India grows around 7.5%, it should be seen as an achievement. Potential growth can only be realised if both demand and supply work in tandem which clearly has been missing in India.

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