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India's Economic Challenges

By Anne O. Krueger

For more than three decades after independence, the pace of Indian economic progress was very slow relative to other developing countries. This was dubbed "the Hindu rate of growth": an annual average of 3.8 percent in real GDP — less than 2 percent per capita over the period since independence. This contrasted sharply with China's growth after the early 1980s, which rose dramatically to an average above 10 percent. Japan, South Korea, Taiwan, and Singapore were also developing very rapidly, and even the Southeast Asian economies were growing at almost double the Indian rate.

Eventually, an economic crisis in 1991-92[1] led to a major shift in economic policy and, with it, an accelerating growth rate. Indian software became world class and its share of the global market rose rapidly; India's multinationals made significant acquisitions abroad; inward foreign direct investment picked up markedly; and, most importantly, the poverty rate fell. India took its place among the BRICs — a term that refers to the large, rapidly growing, emerging economies of Brazil, China, India, and Russia.

But since 2011, growth has faltered. It slowed dramatically in 2012 and fell below 5 percent in the first half of 2013. At the time of writing (September 2013), the government is confronting major economic challenges: The rupee has depreciated sharply; official reserves have dropped

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1 The Indian fiscal year is from April 1 to March 31. So 1991-92 refers to the year starting April 1, 1991. I refer to calendar years for data that are available on a calendar year basis and the years starting April 1 when the data are so presented.

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and capital outflow seems to be accelerating; the current account and fiscal deficits are both at unsustainable levels; and inflation is near the politically dangerous annual rate of 10 percent. Unfortunately, it remains to be seen whether the Indian government can find the political will to enact the difficult reforms necessary to respond to these challenges and re-ignite rapid growth, especially with elections due before May 2014.

The current situation can best be understood in the context of economic policies that led to the slow growth, the policy reforms after the 1991-92 crisis, and the stalled reforms over the past decade.

Economic Policies and Performance, 1947-1991

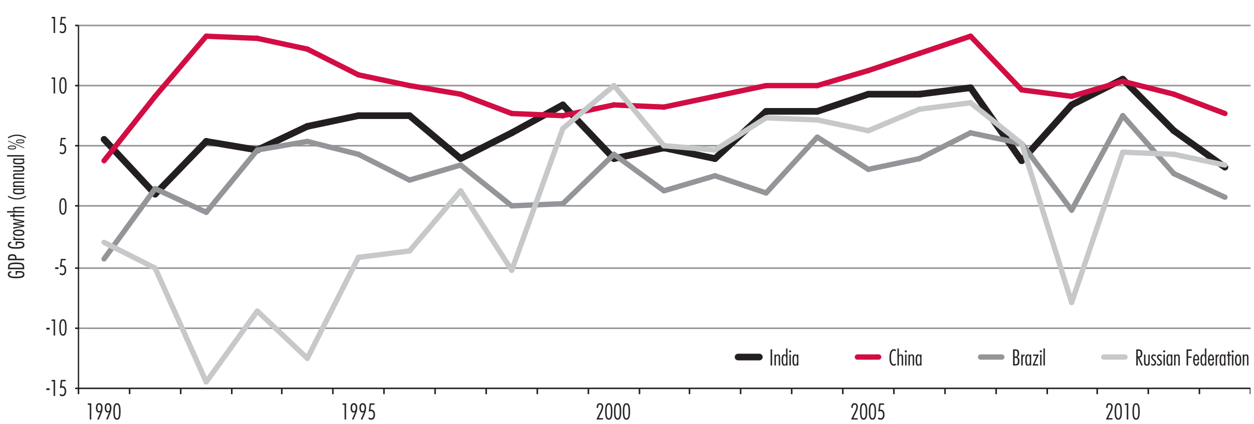
Mahatma Gandhi and Jawaharlal Nehru placed the need for rising living standards at the center of their vision for an independent India. In the developing world of that time, it was widely believed that the way out of poverty was to "industrialize." Since most manufactured goods were imported, it followed that there had to be "import substitution"; domestic producers would be given sufficient incentives to establish facilities that could produce domestic substitutes for imports.

For the first several years, things went reasonably well. But then things started going wrong fairly quickly. India's first "balance of payments crisis" was in 1958, as exports had grown slowly while demand for imports had burgeoned. In part, this was because the government's planners had underestimated the import content of their investment plans. More important, however, were that the rupee exchange rate was fixed, the Indian inflation rate exceeded that of the rest of the world, and the incentives for import substitution greatly exceeded those for production for export.

In response to these difficulties, policies associated with import substitution became ever more restrictive, especially after a second "foreign exchange crisis" in 1966-67. Indeed, as the situation worsened, imports were

Chart 1

GDP Growth (1990–2012)



allowed only when the would-be importer could prove there were no domestic substitutes available. The restrictiveness of the import regime, of course, gave domestic producers a monopoly and led to high prices, poor quality, and significant delays in filling orders. Export growth was slow in part because of the increasing overvaluation of the rupee, as already mentioned. And, as import prohibitions affected more and more goods, the chances for a firm to enter the export market retreated further, as it had to depend on high-priced, low-quality, domestically produced inputs. One measure of the degree to which India's exports faltered (in a period of robust growth for world trade) is that the country's share of world exports fell from 2 percent in 1950 to 0.5 percent in 1990.

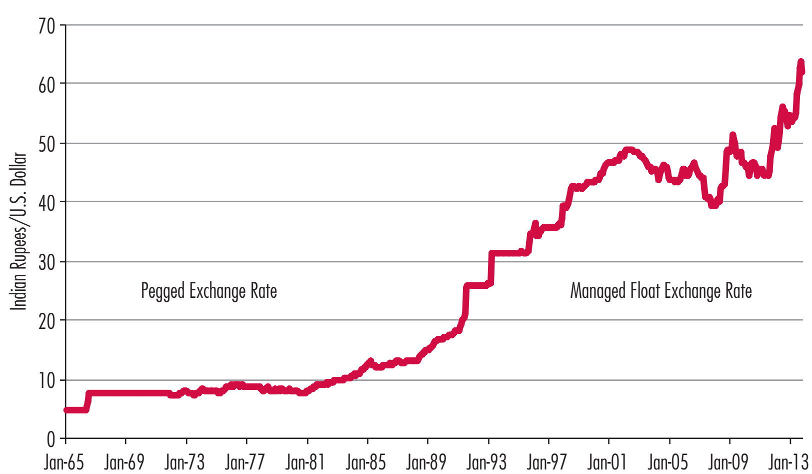
Unfortunately, India's problems did not stop there. By the late 1980s, more than half of all investment had taken place in state-owned enterprises (SOEs), but they produced less than a quarter of total output. Moreover, all private firms above a small size had to be licensed, a policy that included a limit on the amount that could be produced! Even worse, "small-scale reservation" listed more than 800 industries "reserved" for small-scale industry, defined in terms of the number of workers employed.

These and other inefficiencies kept the growth rate slow. In trying to remedy the situation during severe crises, the government adopted a series of ad hoc measures that included special incentives for exports (that by no means compensated for the greater incentives for import-competing production), a somewhat more realistic exchange rate (which, being fixed, soon became overvalued again), and efforts to alleviate some of the difficulties producers encountered. Although growth would pick up somewhat each time, after each crisis the growth rate became somewhat slower and the contrast between India's performance and the greater success of East and Southeast Asia became increasingly pronounced.

The Crisis of 1991 and the Reforms

Although growth picked up somewhat in the 1980s, it was largely in response to fiscal stimuli rather than much-needed supply-side reforms. By 1991, the situation had deteriorated significantly and was unsustainable. But compared with the crisis' precursors, which were addressed using

Chart 2
India/U.S. Exchange Rate, Rupees/Dollar
(1965-2013/10, Monthly)



temporary, band-aid remedies, the 1991 crisis produced a very different set of reforms and a different result. The measures undertaken were far-reaching and policymakers sought to alter the underlying economic policy stance. Not only was the rupee devalued, but over the next several years there was a gradual shift to a managed float (Chart 2). As a result, the real exchange rate no longer appreciated systematically between crises, and firms considering exporting had some assurance that their foreign exchange receipts would maintain their value in rupees.

These measures, by themselves, would have transformed the economy. Reforms, however, went far beyond liberalizing the exchange rate. The capacity and investment licensing regime was dismantled and small-scale reservation was gradually abandoned. Although the banks (mostly state-owned) were still subject to direction in the allocation of credit, the Reserve Bank of India (RBI) was no longer required to buy newly issued government debt, thus freeing monetary policy from total subservience to fiscal policy. Moreover, a fiscal responsibility law was passed early in the 2000s, and the government's deficits, which had risen again after their drop in the mid-1990s, began falling, albeit slowly.

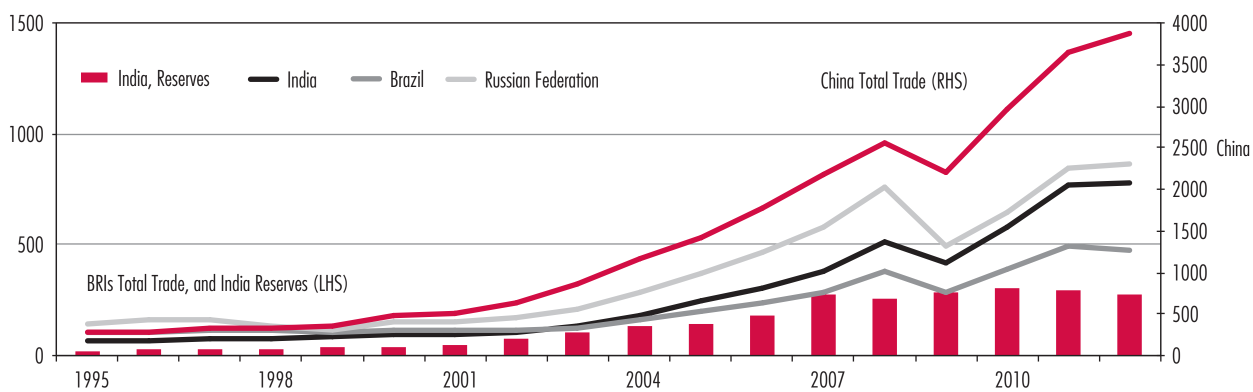
The New Indian Economy

Taken together, these policy shifts were enough to alter the economy's performance dramatically. The rate of real GDP growth rose from an average of 4.0 percent in 1990-93 to 7.1 percent between 1993 and 1997. It fell to 5.2 percent for the years 1997-2003, before rising sharply over the subsequent five years to be discussed below. Per capita income is now estimated to be around $1,500, still much less than the emerging market average of $10,000 but much more than it was earlier.

As the real exchange rate became more predictable and the import substitution regime was dismantled, trade began rising rapidly (Chart 3). Whereas exports were only 6 percent of GDP just prior to the crisis, they rose to almost 25 percent of GDP by 2012 (imports had risen to around 30 percent). India's share of world exports increased to 2.5 percent by 2012, more

Chart 3

Total Merchandise Trade and Foreign Exchange Reserves (1995–2012), Billions U.S.$



than double what it had been a decade earlier and 5 times what it had been at its nadir. But the success of Indian companies internationally was even more spectacular. After selling less than 1 percent of world software exports in the early 1990s, the sector grew so rapidly that by 2012, WTO data showed India as the world's sixth largest software and services exporter with 3.4 percent of the market.

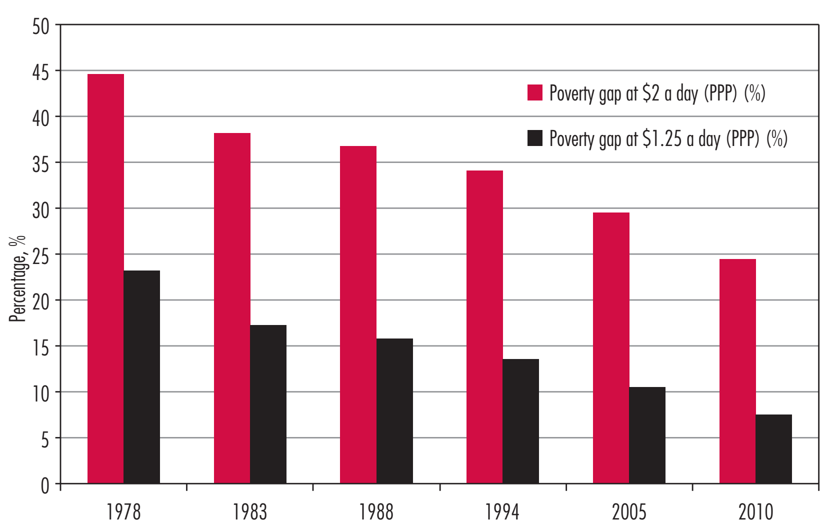
Likewise, the savings rate rose from around 24 percent in 1990-91 to more than 37 percent by 2007-08. This took place not only because of faster growth but also because of increased corporate savings as profitability rose. Because the fiscal deficit was falling during this period, the problem of crowding out of private investment was greatly diminished. The high savings rate and the shift to more efficient investment accounted for much of the growth. Nearly all estimates have shown a significant reduction in poverty, although India still has a very large share of the poor people in the world. The poverty rate, which was 55 percent in 1973-74 and 36 percent in 1993-94, fell to 27 percent by 2004-05. (Chart 4)

If the results of the reforms were good up to 2003, they were spectacular in the following five years. Growth accelerated and averaged almost 9 percent. It even exceeded China's for a short period. A boom in exports and investment coupled with a stable macroeconomic situation led to a sharp increase in optimism. Many believed that a new, faster growth rate had been achieved and would be sustained.

However, despite the reforms that had been implemented, many unfinished tasks remained. For example, there was little change in labor laws and regulations. As a result, the relative importance of manufacturing grew slowly. Unskilled labor-using industries (such as clothing and footwear) failed to expand as they had in other reforming countries (e.g., Korea in the 1960s and 1970s; China in the 1980s and 1990s), and although there was some growth in manufacturing output, there was almost no increase in the employment of unskilled labor in manufacturing, as businessmen substituted scarce capital for abundant labor.

Even more problematic, despite the reforms, there remained multiple inefficiencies in the government's economic management. As late as 2009, India ranked 122nd globally (out of 181 economies) in the ease of doing business. For

Chart 4
Poverty Rate in India



example, enforcing a contract was estimated to take an average of 1,420 days, and businesses had to pay 60 different taxes annually, amounting to a total tax rate of 71 percent. (These numbers, and other indicators, may be found in the World Bank's Doing Business, 2009 edition.)

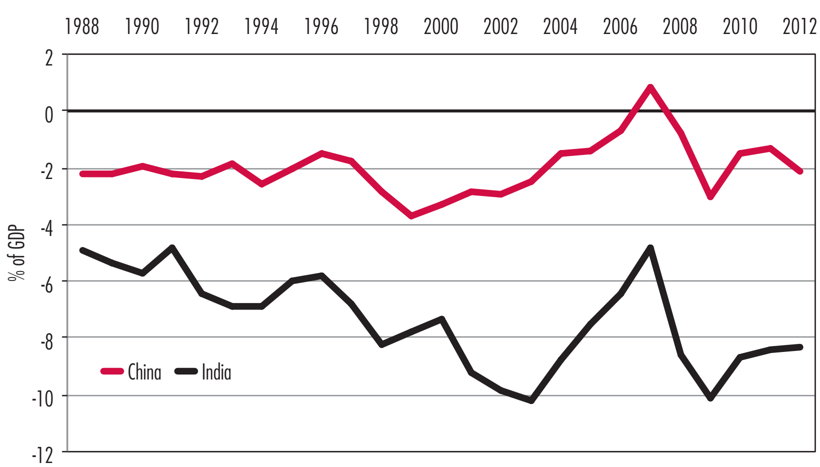
As growth had accelerated, India's lagging infrastructure development increasingly became a bottleneck and source of inefficiency. There were major delays in ports relative to India's competitors, leading some firms to shift operations to other countries that had faster turnaround times and lower costs. The World Bank ranked India 90th for ease of trading, estimating that it took 17 days to export from India, whereas the number for Singapore, for example, was 5. The cost of a container shipped from India was $945, compared with $456 from Singapore. Internally, road congestion and outdated rolling stock plagued ground transportation. But perhaps worst of all, there were power shortages throughout the country, forcing businesses to install (expensive) generators and/or suffer costly disruptions to production.

Emerging Difficulties

India's growth rate held up well through 2007-08, and although it fell in 2008-09, it remained above 6 percent. This represented a much less severe drop than was taking place in many countries. Then, due to government stimulus, growth accelerated to 8.6 percent in 2009 and 9.2 percent in 2010. Consequently, when growth began lagging again, there was little fiscal space for further stimulus. The growth rate fell to 6.2 percent in 2011 and has continued to decline, reaching only 4.4 percent in the April-June quarter of 2013.

In the short term, the fiscal deficit itself is a problem. Much of the stimulus spending, which included increased salaries and subsidies, was difficult to reverse, so the deficit remains high, contributing to inflationary pressures and once again crowding out private investment (as public- sector savings fell). And in recent months, several things may have derailed Finance Minister Chidambaram's plan to reduce the central government deficit in the current year to 4.9 percent. First, oil prices have risen. The government imports oil but puts a ceiling on the domestic retail price, compensating the oil companies with a subsidy for the difference. This cost has

Chart 5
Central Government Deficit as % of GDP
(1988-2012)



disproportionately increased. Second, the government's recently passed Right to Food Act guarantees free food grains to two-thirds of the population. Concerns about its impact notwithstanding (many claim that malnutrition is more often a result of overly heavy intakes of food grains and under-consumption of nutritional foods), its cost is estimated at between 0.5 and 2.5 percent of GDP. As well, the slowdown in growth is almost certain to result in expenditures over budget and revenues under budget. Hence, the problem not only remains unsolved, but the outlook has deteriorated.

Another related short-term problem is that the current account is in deficit by just under 5 percent of GDP. Until the growth slowdown, inflows of foreign capital had been covering a large portion of the (smaller) deficit. But with declining growth and an increasing current account deficit, inflows have stalled. As of the time of writing, India held enough foreign exchange reserves to cover seven months of imports, but there are significant concerns about the possibility of increased capital outflows in the coming months.

Declining capital inflow contributes to yet another, and again related, short-term problem: the depreciation of the rupee by around 20 percent between May and August 2013. Although many emerging economies saw their exchange rates depreciate over that period, the rupee's fall was the largest. Rupee depreciation may stimulate exports but, at the same time, many private firms have large outstanding foreign debts and their ability to service their debt could be impaired by a depreciated exchange rate.

Thus, India faces a number of short-term challenges. Some, including rupee depreciation, capital flows, and the fiscal deficit, are issues that must be tackled in the short run. But because of impending elections, the likelihood that sufficient policy action can be taken is much smaller than might otherwise be expected.

Moreover, many other issues also need attention if India is to sustain annual growth of 9 to 10 percent. Enhanced provision of infrastructure (with some degree of priority to power) and major efforts to improve labor and land markets are desperately needed. In addition, the quality of education raises concerns, as a large increase in the number of students has overburdened India's schools. As noted, bureaucratic delays as well as unnecessary regulations and procedures still weigh on many activities, even if somewhat less heavily than before. The financial system needs further diversification and strengthening, with reduced reliance on regulated banks and greater emphasis on other financial institutions.

The reforms following 1991 showed what can happen when an outdated set of policies is changed. Economic growth was so fast, however, that more reform is now needed to adapt to the new economy and spur growth. The five years from 2003 hinted at India's tremendous potential. But that early success obscured many of the further policy reforms needed to sustain growth. Hopefully, current difficulties will lead to timely, short-term corrective measures, along with renewed determination to tackle underlying issues, thus restoring in the Indian economy the rapid economic growth of which it is capable.

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