NATIXIS

FLASH ECONOMICS
ECONOMIC RESEARCH

January 30, 2012 – No 80

India's growth model (and its limitations)

This report explores the idea that India's economic slowdown is primarily explained by the limitations of its growth model and less by the problems caused by the global situation.

Focusing too much on services in urban areas, India's economic growth is "creating" the current deficit (since only a small share of services is exported) and inflation (since the rise in agricultural productivity is low and demand for foodstuffs is high) is intensifying income inequalities (absorption of excess labor in rural areas is very slow) and is nurturing public deficits (the State is trying to offset increased income inequality by establishing aid programs).

The domestic financial system also devotes too many resources to finance the public deficit, such that funding for heavy investments (not associated with urban services) is partly limited by the availability of external savings.

India's growth and enormous economic development potential will clearly continue to draw interest from foreign investors over the coming years.

It is worth noting the presence of macroeconomic imbalances that could increasingly expose the growth path and performance of financial variables to "stop & go" type movements.

ECONOMIC RESEARCH
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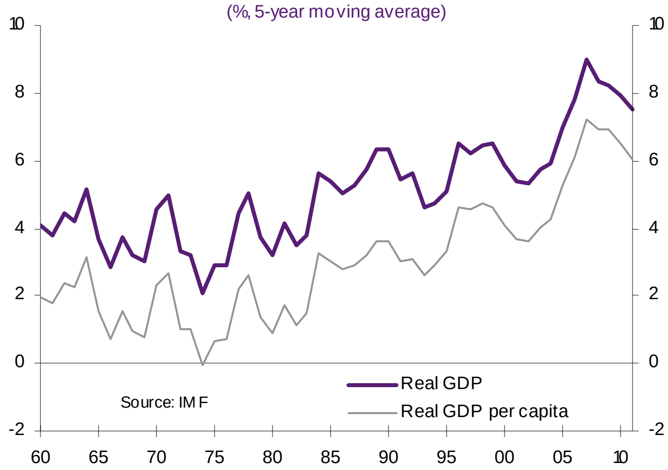
An economy with high growth potential

In recent years, India's economy has had one of the highest growth rates in the world, caused by heavy investment by the dynamic private sector. The lengthy growth cycle that started in the 1990s is the strongest and longest experienced by the Indian economy (**Chart 1**).

Chart 1. India: Real GDP growth
(%, 5-year moving average)



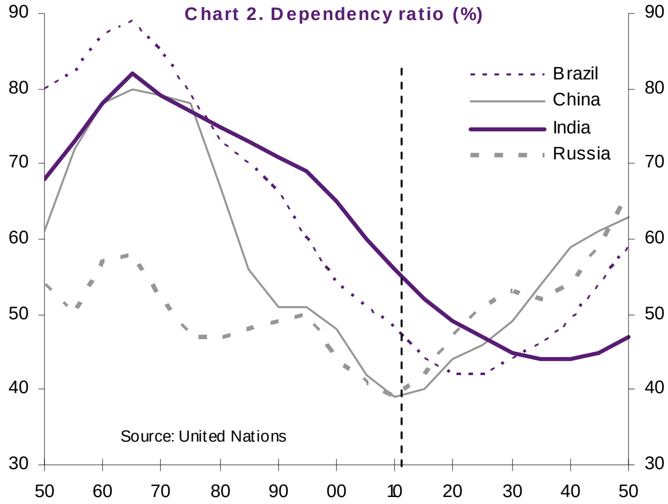
More liberal minds put India's success down to the reforms for financial deregulation and gradual liberalization of foreign investment and trade, introduced in 1992 as part of a structural program under the supervision of the IMF and World Bank, which came to the country's aid during a balance of payments crisis[1].

The most noteworthy outcome of these reforms was the positive impact of dismantling the advance authorizations system for investment in industry ("*license Raj*"), which protected small industry from risks linked to concentrations of capital but, which also limited the scope of achieving economies of scale. As the country opened up trade (joining the WTO in 1995), it entered the global economy, specializing in IT and business services in the world of international outsourcing.

"The demographic dividend"

Yet a key factor of India's dynamic economy is its demographics. Since the 1990s, the ratio of the country's working-age population has experienced a period of growth (**Chart 2**), opening up a window of opportunity that explains the upward trend in the nation's savings rate, and hence the availability resources for funding investment (**Table 1**).

Chart 2. Dependency ratio (%)



[1] The country was suffering the consequences of the collapse of the USSR (its main trading partner at the time) and the Gulf War, which resulted in an oil crisis and a serious loss in earnings from cash transfers by the diaspora of Indians working in the Middle East.

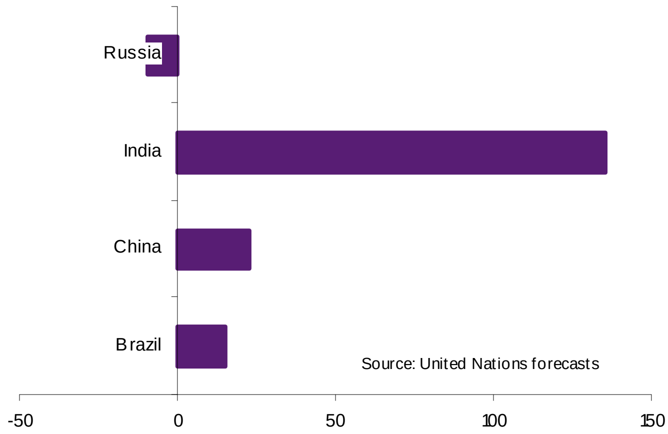
Table 1. Savings & investment (% GDP)	1960	1970	1980	1990	2000	2010
Net savings - households	5,4	8,0	10,8	14,9	20,7	21,4
Net savings - corporate	0,6	0,5	0,8	0,9	2,0	4,8
Net savings - public sector	0,7	1,1	1,7	-2,3	-4,8	-0,8
GFCF - total	12,9	14,8	19,7	25,0	26,2	32,9
GFCF - public sector	6,7	6,1	10,1	11,5	7,5	9,0
GFCF - households (*)	1,6	1,2	1,8	3,7	6,7	11,6
GFCF - corporate	4,6	7,6	7,8	9,7	12,0	12,3

Source: Central Statistical Organization

(*) Mainly residential construction

India offers the most promising prospects of all emerging economies in terms of its "demographic dividend" in the future. Its working-age population (potential savers) should grow substantially over the coming years (**Chart 3**).

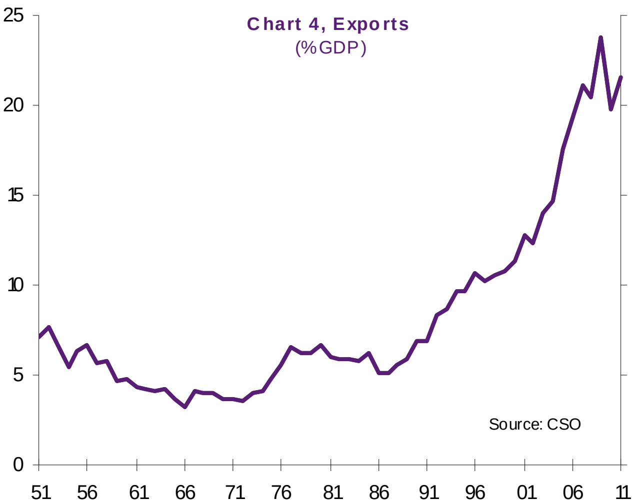
Chart 3. Forecast growth of labor force
(between 2010 & 2020, millions of people)

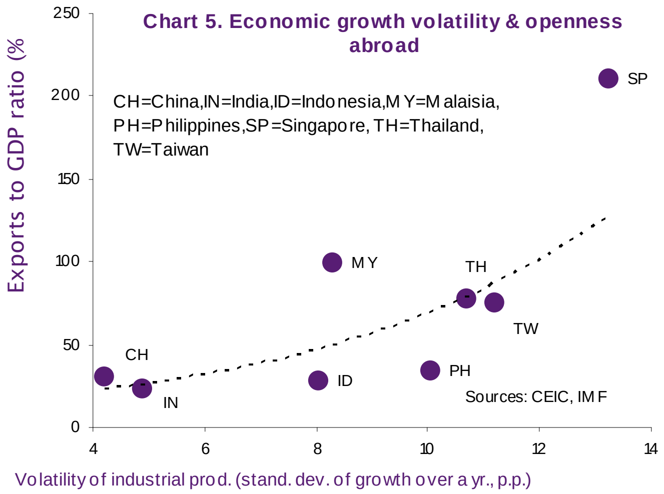


A dynamic domestic market

India's economy is reliant on the growth of its enormous domestic market.

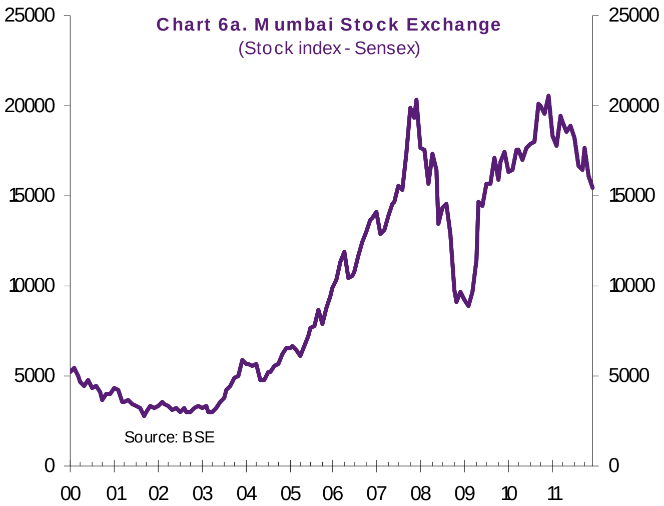
Although India abandoned its growth model based on self-sufficiency for one that opens up the country to the outside world, its production is still mainly directed at the domestic market. In spite of a spectacular leap in its exports to GDP ratio (**Chart 4**), it is still one of Asia's lowest (**Chart 5**).

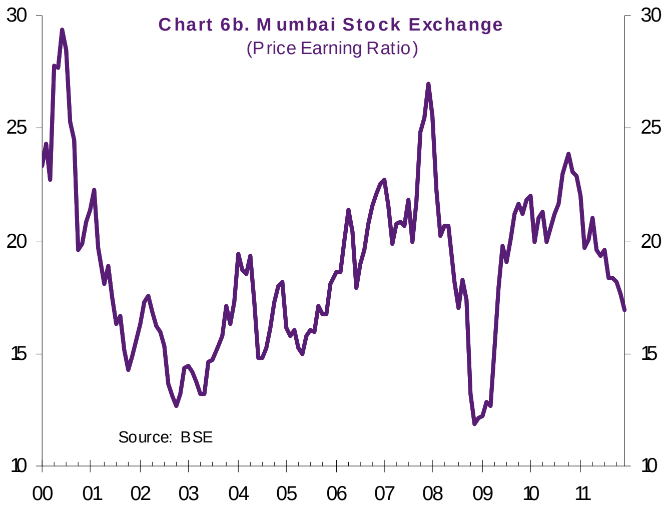




This characteristic has protected the real economy from the contagious effects of global financial and trade shocks following the subprime crisis at end-2008 and tensions over European debt in 2011.

And although the markets have not been spared financial turmoil (**Charts 6 & 7**) with economic activity slowing, India's economy has still managed to generate one of the highest leaps in income per capita over the last three years (**Chart 8**).





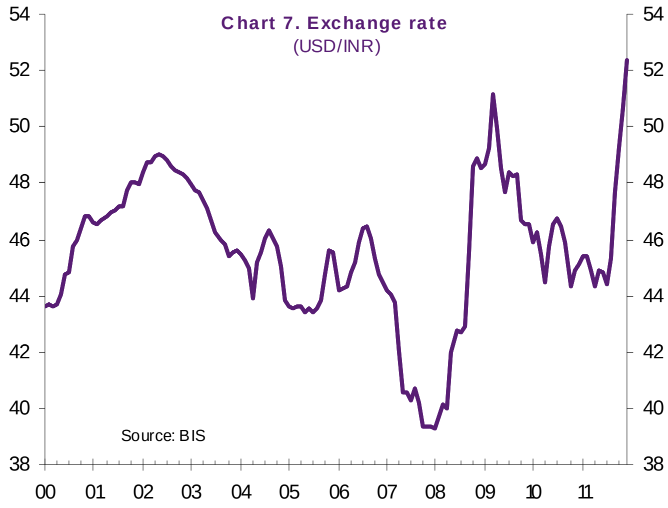
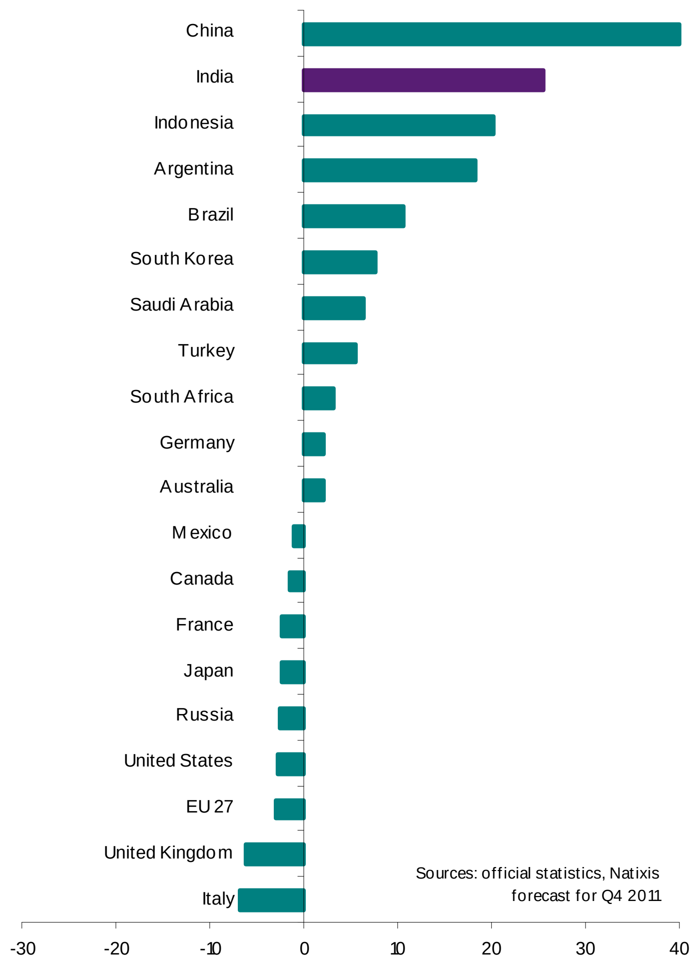


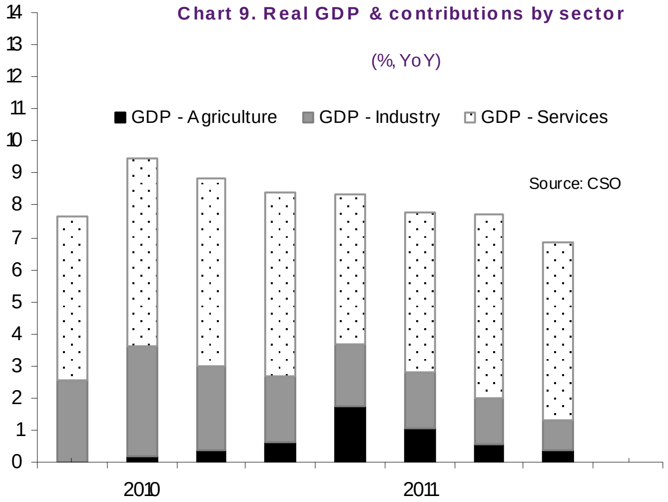
Chart 8. Change in GDP per capita, constant prices, between Q4-2007 & Q4-2011, %

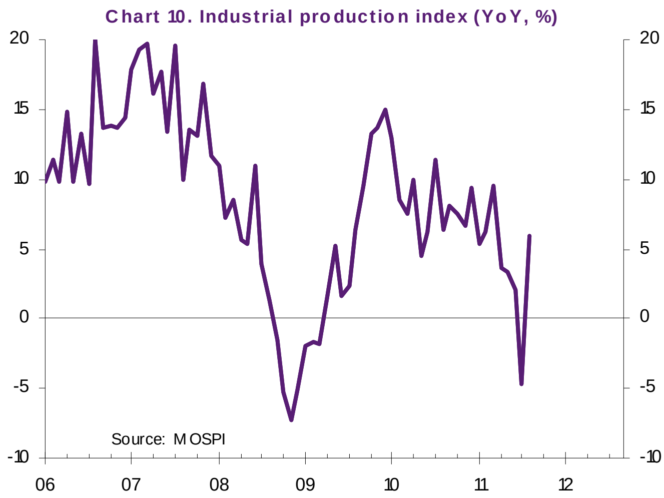


India's growth and enormous development potential will clearly continue to draw interest from foreign investors over the coming years. It is still worth noting the presence of several macroeconomic imbalances that are not without their risks and which may put growth (and the performance of financial variables) on a more erratic path than in the recent past.

A service-based growth model…

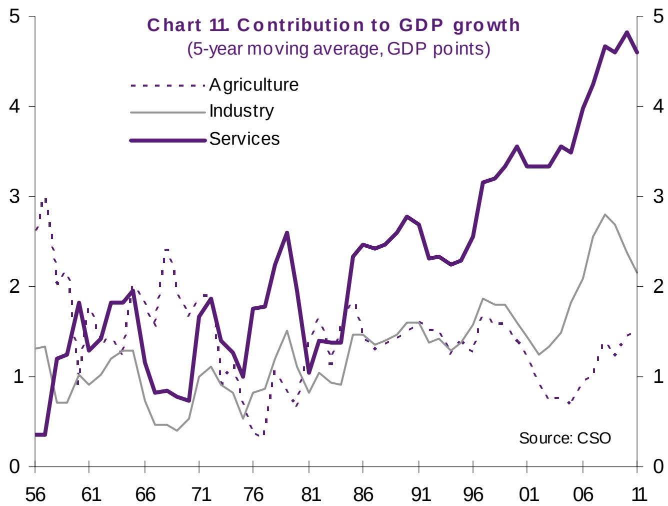
In spite of the uncertainty that continues to burden the global economy, growth has remained dynamic in India, up 6.9% in a year in the second quarter 2011/12 (July-September). This increase, one of the most rapid in emerging Asia, is still the country's lowest for the past eight quarters, accompanied by a marked slowdown in manufacturing activity (**Charts 9 & 10**).



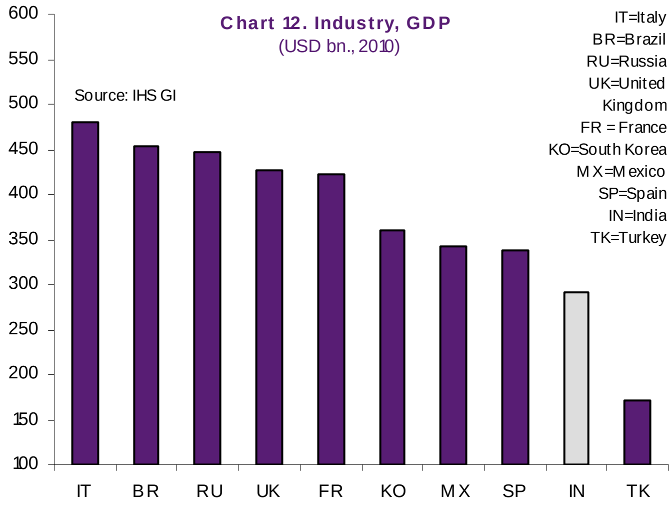


The stagnation in manufacturing activity has raised questions about the "structural" constraints on the expansion of India's industry.

It first reminds us that India's economy is primarily a services one, with the sector being mostly responsible for the country's dynamic performance since the 1980s (**Chart 11**).



India's industry clearly saw great expansion in the 2000s with some Indian companies starting to gain international renown, such as the legendary Tata, alongside Mittal, Reliance, Mukesh, Anil and Mahindra. Yet the overall size of Indian industry, regardless of the huge domestic market, is still on a par with smaller countries (**Chart 12**).



Indian industry is suffering from underdeveloped heavy infrastructure. Such problems are illustrated by the state of the country's roads, continued power outages and limited access to drinking water, which cause bottlenecks and low elasticity of supply for industrial goods. While improvements are under way, infrastructure development in India is still a very long process.

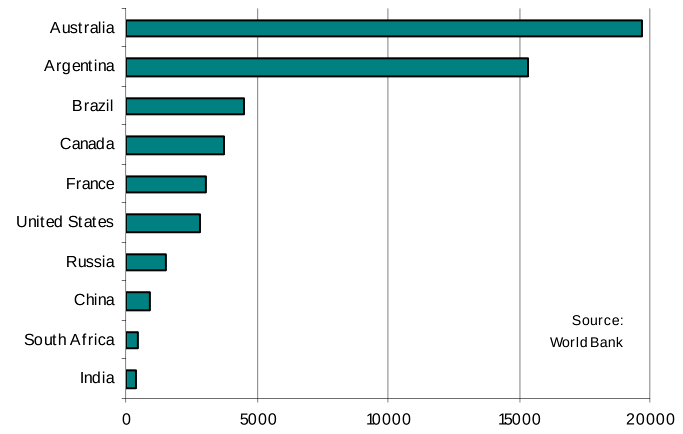
The levels of capital accumulated during the 2000s primarily favored the expansion of businesses in the urban services sector (commerce, finance, **Table 2**). There was comparatively less investment in infrastructure in urban areas (inter-city connectivity, modernization of airports, telecommunications) than in rural areas (irrigation, electrification, storage), and in infrastructure necessary for industrial development (energy, access to water, road network).

Table 2. Progress in investment & infrastructures

	Heavy & basic	Rural	Urban	Financial	Human capital
Overall progress	Insufficient due to lack of funds, weaknesses in long-term planning & poor implementation	Partial improvement	Gradual improvement	Reasonably strong	Two-tier growth – strong in urban segments; but weak overall
Strengths	Telecoms, petrochemicals	Improvement in standard of living (e.g. telecoms), moderate progress with drinking water, health	Rail links, modernization of airports in progress	Banking system in good health / strong Central Bank	Urban institutions – education, health
Weaknesses	Electricity, highways, mining sector	Main rural infrastructures – irrigation, storage, electrification, education, health	No widespread, forward-looking urban planning program	Cooperative banks	Sub-optimal mechanism for implementing government programs
Sector dependence on different categories of infrastructures					
Agriculture	Average	High	Low	Low/average	Low
Industry	High	Low	Low	High	Average
Services	Low/average	Low	High	High	High

India's rural sector is also still underdeveloped (**Chart 13**). The country has been food self-sufficient since 2000, but around 237 million people (21% of the population) are still undernourished according to FAO data. Some progress has been made under the "*Bharat Nirman*" program, aimed at developing rural infrastructures (including irrigation and access to drinking water) and providing financial aid to farmers that are heavily in debt.

Chart 13. Agriculture, GDP per capita (USD)



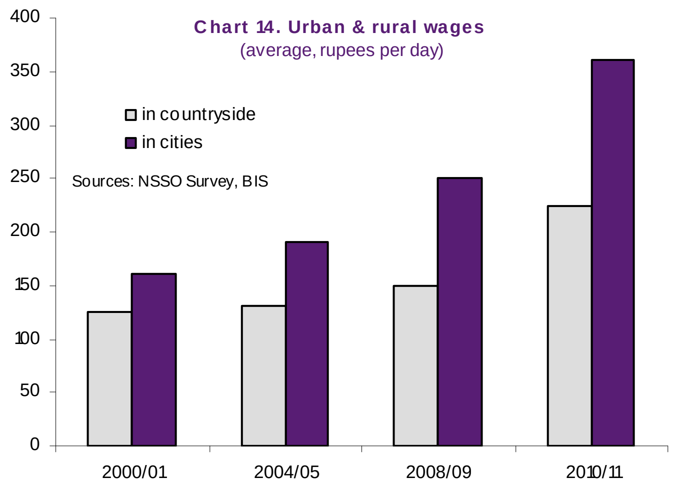
Boosting agricultural productivity is a crucial issue for the country, made even more critical since the population is growing at a rapid pace. But intensive farming using fertilizers is causing environmental problems (soil erosion, water pollution, falling water tables, etc.), casting doubt over the sustainability of Indian agriculture.

…that creates macroeconomic imabalances

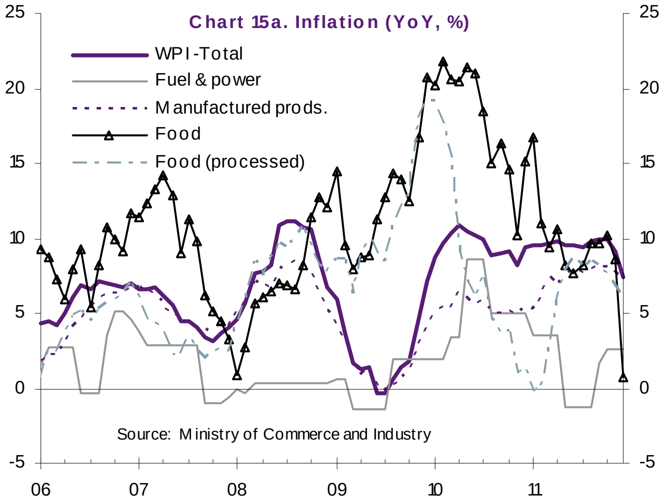
From a macroeconomic standpoint, this primarily service-driven growth together with only moderate expansion in the agricultural and manufacturing sectors, poses numerous challenges which are examined below.

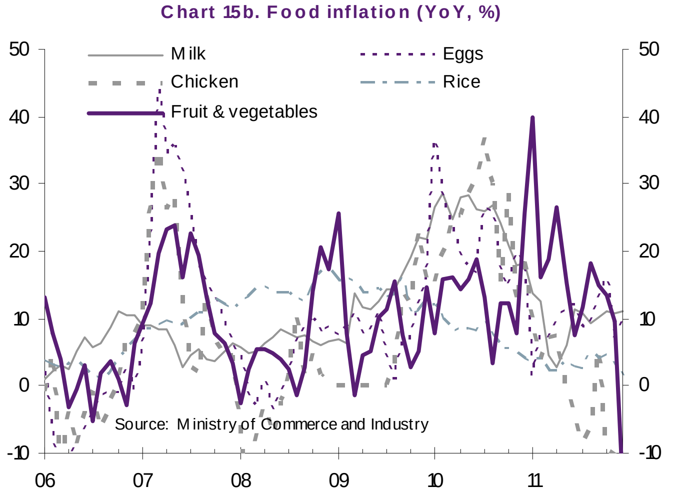
i) Income inequality and "structural" inflation

First of all, this growth imbalance produces income disparities between the rural and urban sectors (**Chart 14**). While poverty has certainly declined (from 45% in the 1990s to 38% in 2010, based on official figures), serious inequalities remain and are even intensifying, as confirmed by the Gini Index which shifted from 0.32 in 2000 to 0.36 in 2006 (based on World Bank data).



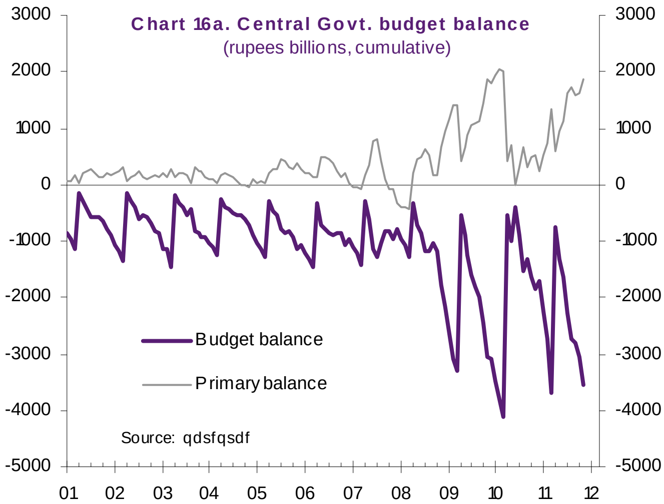
The pro-urban and pro-services bias of India's growth produces a problem of "structural" inflation, i.e. separate from the policy mix (whether expansionary or restrictive in nature). The surge of the middle classes (2.7% of households in 1995 compared to 12.8% in 2010) in cities is substantially boosting demand for foodstuffs that were previously reserved for a select few (milk, meat, eggs), while agricultural output is only growing very slowly. And considering the country's food distribution system, whose level of efficiency is questionable, this dynamic is a key cause of highly inflated and very volatile food prices (**Charts 15a/b**), especially when harvests are not blessed with a generous monsoon. Lastly, food inflation tends to be self-perpetuating. When high, inflation spreads to manufactured products and services, with wage-related second-round effects, while around 40% of consumer spending is on foodstuffs.

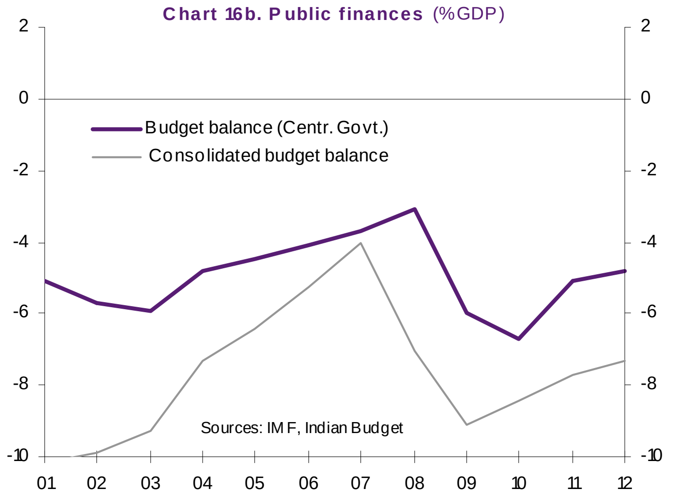




ii) A perpetual budget deficit

Such growth imbalances cause a deterioration in public finances and, although the 2003 Law on budgetary management and responsibility has helped to streamline public finances considerably, the deficit deepened in 2008/09 and in 2011/12 (**Chart 16**).





Effective tax collection is being widely addressed via measures such as tax relief for major special economic zones (manufacturing production destined for export (**Box 1**)), but India's public finances are suffering from a rising need for government aid in less-privileged areas. The Government has embarked on programs such as the National Rural Employment Guarantee Scheme (**Box 2**). It has also introduced a debt relief program for small-scale farmers. And to tackle the surge in oil prices in 2008 and 2010, the Government decided to cushion the impact on domestic prices by raising subsidies, amounting to 2.2% of GDP in 2011/12 versus 1.3% in 2005/06. Lastly, in 2009, the Commission entrusted with reviewing public service wages every ten years recommended increases of around 40% with sizable adjustments. All of these factors (particularly rural aid) continue to burden public spending, while capital expenditure, which could raise elasticity of supply, is limited by the Government's low revenue performance.

At a time when public funds needed to develop infrastructures are inadequate (central Government revenues account for just 9% of GDP), reforms still seem necessary to sustain investment.

The problem for the public deficit is less its financing (bank regulations require banks to invest 24% of their assets in treasury bonds) and more the fact that it causes a "crowding-out effect" which reduces the funds available to invest in infrastructure development.

Box 1. Special economic zones

One of the factors of the expansion of India's industry has been the take-off of special economic zones (SEZ) since 2006, the year the Law on ZES entered into force. The objective is essentially to create free-trade zones for the export industry to help overcome India's many traditional obstacles to growth. ZES are exempt from all customs duties and they also enjoy some tax relief measures for the first ten years. A one-stop shop system allows companies to avoid costly administrative formalities. Over the space of five years, exports from ZES have multiplied 15-fold and today account for almost a quarter of all goods and services exported, according to statistics from the Ministry of Commerce and Industry.

Box 2. The National Rural Employment Guarantee Scheme

The aim of the National Rural Employment Guarantee Scheme (NREGS) introduced in 2006 is to provide a safety net for people in rural areas and to promote development via funding for small-scale farming and infrastructure projects. This plan guarantees a minimum of one hundred days of employment per year for any member of a rural household wishing to participate, in return for a fixed wage paid by the central Government. Participants can join or leave the scheme depending on their current situation and most opportunities are for unskilled manual labor. Most of the projects involve work on local infrastructures, such as roads and irrigation, and the prevention of flooding and soil erosion.

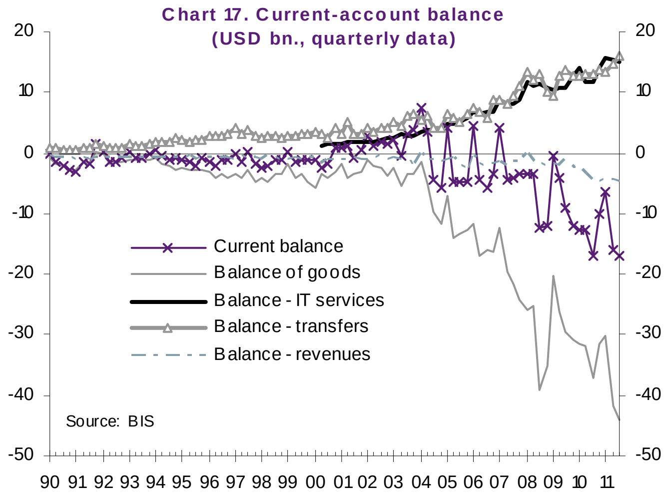
Public funds, mainly from the central Government, cover wages and materials costs. In 2010, the total cost of the program was 0.6% of GDP, with wages accounting for two-thirds. According to official sources, more than 52 million households took part in the program in 2010, compared to 45 million in 2009.

In 2011, the Government announced its intention to index the pay of agricultural workers to the CPI, which implies a 22% hike in the NREGS wage, taking it above the legal minimum wage offered in a number of States.

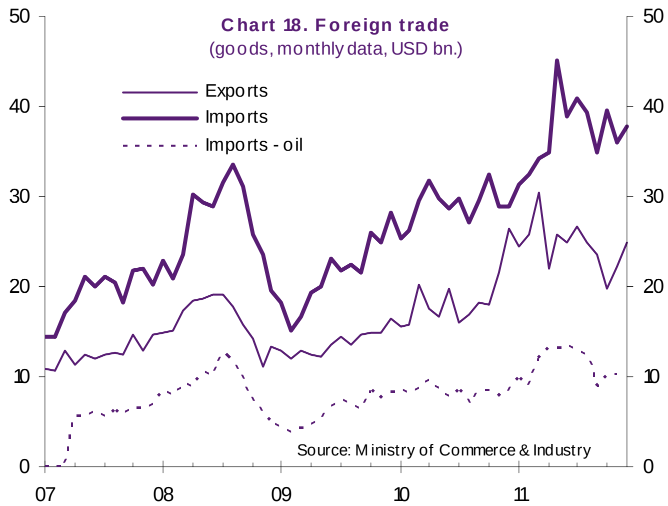
iii) the structural deficit of the current account balance

Lastly, India's pro-services growth path is also at the root of a persistent current-account deficit.

India is clearly a major exporter of IT services and services for business that are at the root of the surplus of services and it receives a substantial amount of money transfers from migrant workers. However, these flows are not sufficient to offset the goods trade deficit (**Chart 17**).



The root cause of the current-account deficit (around 3% of GDP) is justifiably linked to the performance of goods imports and exports: rising demand leads to a sharp increase in imports (particularly energy imports) while exports, which are very dynamic, are growing at a slower pace (**Chart 18**).



India's macroeconomy adjusts to reality

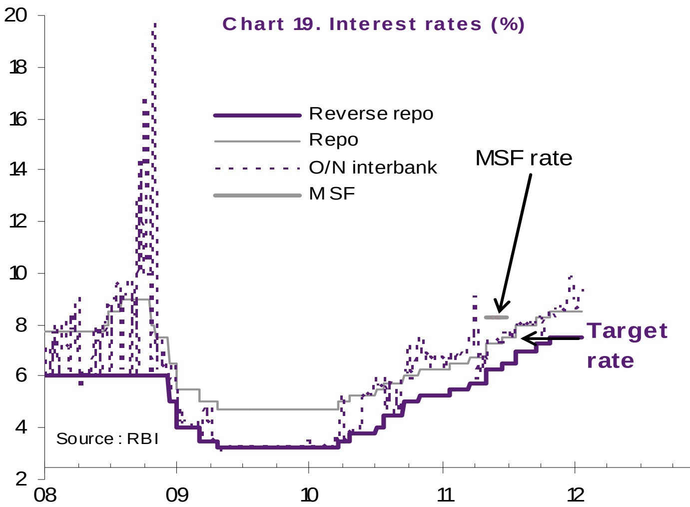
We believe that the current slowdown in India's economy is primarily explained by the limitations of its growth model and less so by the global economic downturn which still accompanies this trend.

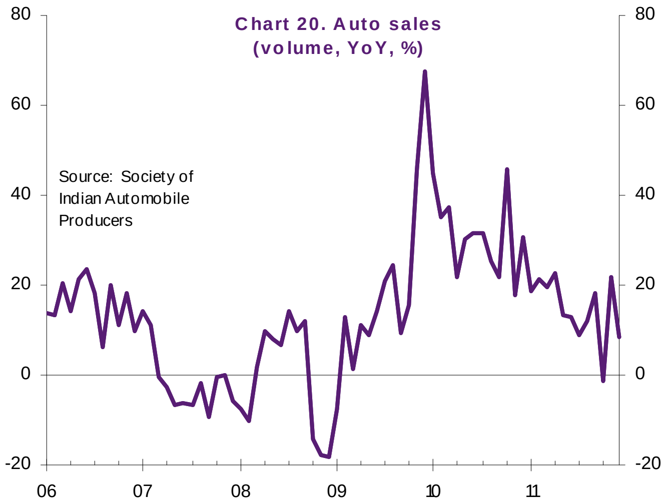
The second half of 2011 was actually the period in which the main economic and financial variables began to balance themselves out (still only partially).

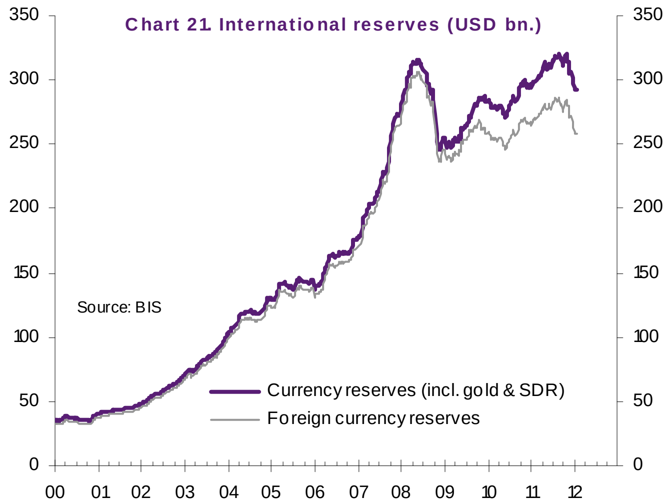
- The monetary tightening policy recommended in early 2011 by the BIS due to the surge of inflation (**Chart 15** above and **Chart 19** below), is reducing demand for durable goods financed by credit (such as automobiles, **Chart 20**) and explains the economic slowdown.

- Periods of heightened risk aversion worldwide are reflected by fewer resources available to fund the external deficit, causing a sharp depreciation in the Indian rupee and the recent decline in currency reserves (**Chart 7** above and **Chart 21** below). Depreciation will eventually weaken the performance of imports and help to reabsorb the current account imbalance.

- The Mumbai stock exchange (see **Chart 7,** Asia's biggest loss-maker in 2011) shows an adjustment in growth forecasts.







With no new wave of reforms that encourage investment in heavy infrastructure (including reforms on tax collection, and with a view to improving efficiency in public spending, providing administrations with more resources), the current growth model could be stretched to its limits.

As things are, there is a growing risk that India's growth will be increasingly exposed to stop-and-go movements: phases of high growth and high global liquidity leading to overheating and accelerated inflation, followed by periods of slowdown (as is the case now) with a depreciating exchange rate and re-absorption of the current deficit, necessary to re-establish the conditions that will allow growth to start up again.

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