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India's economy

India on fire

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India's growth rate is close to China's; but signs of overheating suggest that this pace cannot be sustained

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THE economy is sizzling and foreign businessmen and investors are swarming to Bangalore and Mumbai to grab a piece of the action. India's year-on-year growth rate could well hit double figures at some point in 2007, and the country may even grow faster than China for at least one quarter. But things are so hot there is a big problem: India's current pace of expansion may not be sustainable.

On the face of it, the figures are compelling. India's real GDP grew by 9.2% in the year to last September (the latest numbers available). Over the past four years it has clocked up an average annual pace of more than 8%, compared with around 6% in the 1980s and 1990s—and a measly 3.5% during the three decades before 1980, when highly interventionist policies shackled the economy (see chart 1). India seems to be reaping the rewards of reforms that were made in the early 1990s. These massively lowered barriers to trade and liberalised capital markets. As a result, total trade in goods and services has leapt to 45% of GDP, from 17% in 1990.

Economic growth is likely to remain strong this year, driven by booming investment and consumption. The government's five-year plan to 2011-12 has an ambitious target of 9% average annual growth. Most Indian economists expect at least 8% over the next five years. Some, such as Surjit Bhalla, of Oxus Investments, think even 10% is feasible, thanks to a surge in investment.

Optimism is abundant. Indian businessmen were the most upbeat among 32 countries surveyed recently by Grant Thornton, a London-based accounting firm: 97% of the respondents were bullish about the future. Indians are rightly proud of the huge global success of firms such as Infosys, or of Tata Steel's £5.8

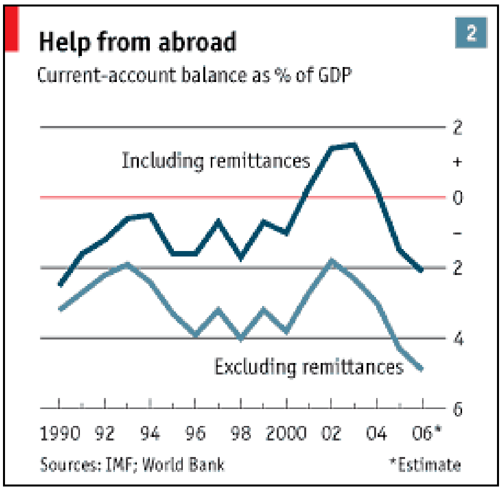
billion ($11.3 billion) acquisition of Britain's Corus this week. They point to new mobile-phone subscriptions, which are running at a higher monthly rate than in China, as evidence of their economy's vigour and modernity. But look again. Perhaps the only thing really growing faster in India than China is hype.

Recent visitors to Delhi were greeted by a poster campaign by the *Times of India* announcing "India poised". But poised for what? The economy is displaying alarming symptoms of overheating. This implies that demand is outpacing supply and hence the pace of growth is unsustainable. Despite lower oil prices, wholesale-price inflation has risen to 6%, which is above the 5.5% upper limit set by the Reserve Bank of India (RBI). India does not have a single rate of consumer-price inflation, but the crude average of the rates for industrial, non-manual and agricultural workers is above 7%. Capacity utilisation is higher than at any time in the past decade and severe skill shortages have caused wages to rocket.

The RBI is also concerned about a credit boom. Bank lending to firms and households has expanded by 30% over the past year. Lending on commercial property is up by 84% and home mortgages by 32%. Asset prices look bubbly. After rising more than fourfold over the past four years, India's stockmarket is one of the emerging world's most expensive, with a price-earnings ratio of more than 20. House prices in many big cities have more than doubled over the past two years.

Against this sweltering background, the RBI's interest-rate decision on January 31st looked timid. It raised its overnight lending rate by a quarter-point to 7.5%, but left the reverse repo rate (which it uses to drain excess liquidity from the banking system) unchanged at 6%. Over the past couple of years interest rates have risen by less than the rate of inflation, so they have fallen in real terms.

The inflation numbers probably understate the degree of overheating. When demand outpaces supply in an open economy it is more likely to show up in a current-account deficit than in inflation. India's deficit widened to more than 3% of GDP in the three months to September—a huge swing from a surplus of almost 4% in the first half of 2004. And the true gap between domestic demand and supply is even bigger. Yaga Venugopal Reddy, the RBI'S governor, recently drew attention to how India's current-account deficit is larger once you exclude the money sent home by Indians abroad. These remittances do not reflect domestic demand or supply, but are more like a capital inflow. Excluding workers' remittances, India's deficit is running close to 5% of GDP (see chart 2)—larger than the equivalent deficit during India's balance-of-payments crisis in the early 1990s.



Keeping up with demand

The risk of a financial crisis is slight, because India has the cushion of $180 billion of foreign-exchange reserves, which is equivalent to 11 months' imports, and its external debt is small. But this misses the point. The reason for concern about India's widening current-account deficit is not that it heralds a financial crisis, but that it is a signal of how supply cannot keep pace with red-hot demand.

Furthermore, unlike China and most other Asian emerging economies, India is heavily dependent on short-term portfolio capital inflows, rather than foreign direct investment, which is longer-term. Short-term capital has accounted for four-fifths of capital inflows into India over the past three-and-a-half years—although, encouragingly, foreign direct investment did pick up strongly last year. This means India is vulnerable to rising interest rates if there is a sharp reversal in the appetite for risk in global financial markets.

How fast can India grow? Most standard methods of estimating the trend—or potential—rate of growth (the maximum at which an economy can expand without triggering a rise in inflation) arrive at figures of around 7%. But business people, investors and an unusually large number of economists, are convinced that India is undergoing a "paradigm shift" and so backward-looking historical data are now irrelevant for assessing future growth.

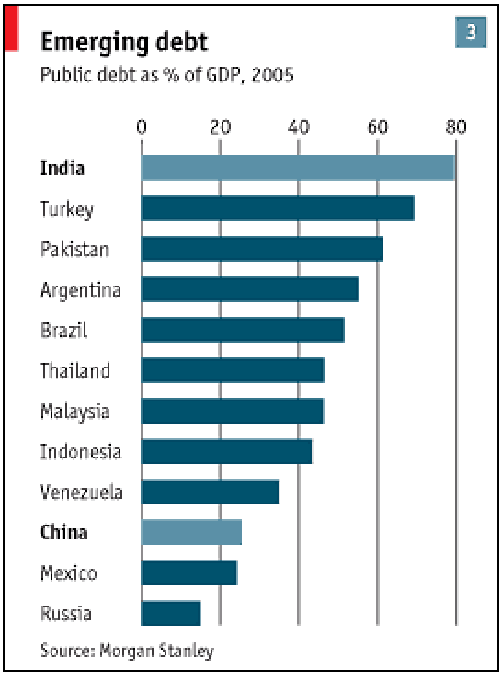
India's capacity for growth has certainly increased over the past decade, thanks to earlier reforms. Yet given widespread signs that India is already exceeding its speed limit, there is a high risk that if the economy continues to grow at 9% or more, it will get ever hotter. Inflation will climb higher and financial imbalances will widen, running the risk of a hard landing. India has no genuinely independent central bank to put on the brakes. And policymakers are understandably reluctant to cool demand when India needs rapid growth to create jobs and reduce poverty.

An alternative to slowing demand is to boost supply by speeding up reforms and attacking the many bottlenecks caused by inadequate infrastructure, dreadful public services, skill shortages and rigid labour laws. But improving infrastructure and education not only takes time, it also requires money, and India's fiscal finances are far from healthy.

On the surface, the government has made great strides to cut its budget deficit. The IMF forecasts the deficit for central and state governments will fall to 6.2% of GDP in the fiscal year ending in March, slightly below budget and down from a peak of 10% in 2001-02. Some of the reduction is due to greater fiscal prudence and reduced tax evasion, but it also reflects a cyclical upswing in tax revenue on the back of the economic boom and low interest rates, thanks to the global liquidity glut. If interest rates rose because foreign investors lost their appetite for risk, or if the economy slowed, the budget deficit would widen.

It already looms dangerously large. Chetan Ahya, Morgan Stanley's economist in Mumbai, calculates that off-budget items, such as oil and power subsidies, amount to another 1.8% of GDP. This puts the total deficit closer to 8% of GDP, the biggest among the main emerging economies. India also has the highest ratio of public debt to GDP, at 80% (see chart 3).

The budget deficit could swell further over the next few years. Generous tax exemptions for exporters in special economic zones may erode future revenues. And the government's Sixth Pay Commission, due to report by April 2008, is likely to lead to a big rise in public-sector pay. Its predecessor's report marked the start of a sharp downturn in public finances; and the new recommendations will be implemented in 2009, an election year.



Again, the concern is not that India's public borrowing causes a financial crisis. Most of it is funded through domestic, not foreign, debt and controls on capital outflows ensure that domestic savers buy government bonds. The real problem is that India's weak fiscal position constrains its future growth by leaving no room for more public spending on infrastructure, education and health.

Leaving the farm

The growth optimists point to India's favourable demography. The population of working age will continue to rise for several decades, whereas in China it is expected to fall. This, it is argued, will boost India's workforce and both saving and investment. Furthermore, 60% of India's labour force is engaged in low productivity farming. As workers shift from agriculture to more productive jobs in industry and services, this will automatically boost GDP growth. Yet this assumes the newcomers will all find jobs. If those jobs do not appear, the so-called demographic dividend will more likely turn into a demographic disaster. Some 60% of the demographic bulge will come in five poor and badly governed states.

This is just one example of how economic commentators tend to confuse India's long-term potential (what is feasible provided the best policies are put in place) with its current potential (ie, non inflationary) growth rate. That India has huge long-term potential is undeniable, but without reforms the country cannot fully exploit it.

All agree that the biggest obstacle to growth of 9% or more is India's infrastructure—especially its lousy roads, ports and power. According to the World Bank, the average manufacturing firm loses 8% of sales each year from power cuts. India spends 4% of its GDP on infrastructure investment, compared with China's 9%. In absolute dollar terms, China spends seven times as much on its infrastructure.

India's government has ambitious plans to increase total infrastructure spending to 8% of GDP over the next five years. This will involve some increase in government spending, but the idea is for the bulk of it to be financed by public-private partnerships. That will be hard.

Private investors, especially foreign ones, still shy away from sectors like electricity and roads because they are uncertain of earning a reasonable return. Only about half of all electricity generated is paid for, because power is stolen and bills are left unpaid. Saumitra Chaudhuri, the economic adviser at ICRA, a credit-rating agency, argues that public-private partnerships first require regulatory reforms to protect the interests of both investors and consumers. As the World Bank put it in a report last year, "when systems are failing, it is not enough to fix the pipes, one needs to fix the institutions that fix the pipes."

Another obstacle to growth in manufacturing is India's labour laws, which are among the most restrictive in the world. Firms employing more than 100 people cannot fire workers without government permission, which discourages expansion. Today's central government cannot scrap these laws because it relies on the support of the communist parties. In theory, the state governments can apply the laws more flexibly, especially in the special economic zones, but this is unlikely to lead to more flexible labour markets overnight.

A third big problem is the dreadful quality of public services, from education and health to the provision of water. Half of urban households lack drinking water within the home; one quarter have no access to a toilet, either public or private. Many public services in cities have worsened in recent years. In Bangalore water is now available for less than three hours a day, compared with 20 hours in the early 1980s. This may be another reason why workers are not moving in from rural areas as rapidly as in China.

Nor are young Indians equipped for more productive jobs in the towns. The quality of education and health care is dire. A survey in 2003 found that only half of paid teachers were actually teaching during school hours. Another survey found that government health centres in poor parts of Delhi had a more than 50% chance of prescribing a harmful therapy for common ailments.

Bizarrely, India has one of the most privatised health systems in the world. Government spending accounts for only 21% of total health spending. Likewise, in eight of 18 states studied more than half of all children in urban areas are in private schools. But this is not a model for free-market economics or the result of policy reform. People go private only because public services are so bad. Subir Gokarn, an economist at CRISIL, another credit-rating agency, worries that because the educated middle class do not use public services, there is less public outcry for reform than there should be.

Sadly, the prospects for dramatic change in the near future look slim. With a few exceptions, such as the partial opening of retailing to foreign investment and the privatisation of the two biggest airports, reforms have stalled since the government took office in 2004. Despite the reformist instincts of Manmohan Singh, the prime minister, the need to maintain the coalition overwhelms the appeal of reform.

Back to school

The supply-side constraints of infrastructure, labour laws and public services seem formidable, yet the vast majority of local economists in Delhi reckon that annual growth of at least 8% is sustainable even without further reform (with reform they look forward to 9% or more). A popular argument is that other Asian economies grew by 8-9% for long periods, so why not India? But East Asian economies invested much more in education and infrastructure than India does today.

A recent study from Goldman Sachs, which forecast that India could sustain 8% growth until 2020, was widely trumpeted in Indian newspapers. However, the bank's report clearly stated that this would require better education, labour market reforms and less red tape. Oddly, most newspapers failed to mention that.

Indeed, it is possible to detect a belief among some that it is now India's "right" to match China's growth rate of 10%. Even the finance minister, Palaniappan Chidambaram, has felt the need to remind people that present rates of growth are not "because some kind god smiled at us". No country "deserves" rapid growth, unless it puts in place the right policies. The biggest danger of today's rampant economic optimism is that it could breed complacency about the need for reforms. That would be a sure recipe for a future slowdown.

India needs faster growth to create more jobs for its expanding population and to make it easier to relieve poverty. The awkward truth is that although the economy is sprinting ahead, most people are only crawling. Although the educated middle class has enjoyed big salary increases and a surge in the value of their homes and shares, the 60% of the population close to or below the poverty line have not yet seen a material gain.

Measured by the commonly used gini coefficient, India has less income inequality than China or America. But it has much more poverty. Some 260m people still live on the equivalent of less than $1 a day. Half of all children under five are malnourished. India needs rapid growth. But by itself that is not sufficient to end poverty, warns Rajiv Kumar, the director of ICRIER, an economic research institute. Better infrastructure and education are needed to make the rural poor more mobile so they have an escape route. In this way, better infrastructure and improved public services can not only increase growth, but also spread the rewards.

To boost sustainable growth, India needs to clear the path ahead rather than risk running an economy beyond its safe maximum speed. Indians are understandably eager for their economy to sprint like a tiger rather than amble along like an elephant. Yet few animals have an elephant's stamina or can travel as far in a day—provided its way is not blocked.