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Is India's Economy Weakening?

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The conventional wisdom concerning the Indian economy has two tenets: (1) India has weathered the financial crisis exceptionally well; and (2) India is *still* undergoing liberalizing reform. Both of those tenets, though, can reasonably be questioned.

Reported Indian GDP growth fell to 6.0 percent in the October–December quarter of 2009, lower than the 6.2 percent in the same quarter of 2008. By itself this decrease is not important, but it comes at a time of high inflation and a dangerously large budget deficit. Under such circumstances, 6 percent growth is not much of an accomplishment. More telling for the long term, this year's budget means the current Congress Party government has further cemented its legacy as reformers in name only.

America's ability to alter this legacy is limited. However, the emerging U.S.–India partnership requires each nation to be direct. Economic negotiations with India should be regarded in part as a means to encourage market reform.

Indian Growth in Context. Three years ago, an economy exhibiting 6 percent real growth, nearly 9 percent inflation, and a consolidated national budget deficit exceeding 12 percent of GDP would have been rightly deemed as heading for serious difficulties. The obvious response is that India should be judged in the context of the financial crisis. However, it is not clear that the economy has actually improved as the global crisis has eased.

India's economic performance may be trending down rather than up. Over the past year, real growth has essentially been stable, the budget situation is worse, and inflation is far worse. In October–December 2008, inflation was not a concern. In December 2009, food inflation hit a decade high and prices as a whole were moving from deflation just a few months earlier toward the 9 percent range in early 2010.[1]

The obvious result is that Indian economic pain is increasing. Food inflation primarily hurts the poor, and broad inflation warps economic decision making. High inflation even clouds the accuracy of core data. Real growth has likely been overstated due to flaws in inflation measurement,[2] where the mistakes are larger when inflation is higher. The government may have mistakenly concluded that 6 percent real growth is inadequate to reduce poverty when in fact high inflation means the 6 percent figure is itself inaccurate.

The government's principal response to economic weakness is to overestimate future growth until forced to recant. In particular, the period of rapid Indian growth earlier this decade coincided with global expansion based on loose money and featured a peak at 9.6 percent in 2006–2007. Inflation then was 4.8 percent, compared to the present 8.5 percent. The federal deficit was 3.7 percent of GDP, compared to 6.8 percent now. Nonetheless, the government anticipates growth exceeding the mid-decade peak. It is far more likely that the

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Indian economy will be considerably weaker than it was a few years ago.

Another Failed Budget. The government has strong motivation to project double-digit growth: the projection is the only way the deficit can come under control. The new budget promises a reduction in the federal deficit to 5.5 percent of GDP. But 5.5 percent was also the original target for this year, and the deficit will near 7 percent.[3]

Twenty percent of the Indian budget is devoted to interest payment. Borrowing accounts for one-third of the federal government's ostensible "revenue."[4] The size of the budget and gross borrowing are both larger than last year. The government continues to hope higher GDP growth will solve all these problems. That hope continues to be fragile.

The same scenario holds in taxes. A unified goods and services tax was supposed to be the headline reform for 2010; instead it has been postponed to 2011 and will likely be far more modest in effect. In that light, it is hard to believe the government's vow of a major overhaul of the direct tax code next year, as well.

There has been limited progress on reducing the subsidies burden. Oil subsidies were cut and brought into the budget rather than hidden away. But fertilizer subsidies remain in excess of 1 percent of GDP while the dollar value of food imports is twice as large as it was seven years ago.[5] Existing programs serve no economic purpose and are merely an environmentally harmful handout, but change remains elusive due to political weakness.

Congress has vowed fiscal responsibility for six years yet spends wildly both when growth is fast and when it is slow. In addition to the future liabilities, the debt contributes indirectly to the current inflation. There is heavy political pressure on the Reserve Bank not to raise rates to limit costs of government borrowing. As a result, inflation is higher and more dangerous than it would be with a properly armed and active central bank.

Restructure, Not Infrastructure. The Indian government's response to all concerns is to cite infrastructure spending. Infrastructure spending, so the official narrative promises, will not only pump up current GDP but ensure a generation of high growth. This is policy based solely on faith.

Government infrastructure projects can be generally characterized as slow, overpriced, and of little commercial value. The norm is for federal infrastructure programs to be late and overrun budget, with many failing to be completed at all. The repeated failures leaves infrastructure in a poor state, which is then used to justify further government spending.[6]

The commercial return on these projects is minimal, as indicated by lack of foreign participation. Although informal barriers persist, full foreign control of public–private infrastructure projects is formally permitted, and there are even monetary

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2. A. Srinivas, "Questioning the Growth Numbers," Hindu Business Line, February 25, 2010, at *http://www.thehindubusinessline.com/2009/02/25/stories/2009022550451700.htm* (March 10, 2010).
3. Kartik Goyal, "India's Budget Deficit Widens to 7-Year High, Ratings at Risk," Bloomberg, May 29, 2009, at *http://www.bloomberg.com/apps/news?pid=20601091&sid=aOAhsgrd2f1I&refer=india* (March 10, 2010).
4. Economic Times, "Union Budget 2010: Where Budget Rupee Will Come, Where It Will Go," February 26, 2010, at *http://economictimes.indiatimes.com/News-Analysis/Where-Budget-rupee-will-come-where-it-will-go/articleshow/5619682.cms* (March 10, 2010).
5. "Additional Cash Fertilizer Subsidy of Rs 8000 Crore Unveiled," Indian Fertilizer, at *http://www.indianfertilizer.com* (March 10, 2010); Geeta Anand, "Green Revolution in India Wilts as Subsidies Backfire," *The Wall Street Journal*, February 22, 2010, at *http://online.wsj.com/article/SB10001424052748703615904575052921612723844.html* (March 10, 2010).
6. Nirbhay Kumar and Subhash Narayan, "Delay in Big-Bang Infrastructure Projects Costs Another Bomb," Economic Times, March 11, 2009, at *http://economictimes.indiatimes.com/articleshow/4251744.cms* (March 9, 2010); Economic Times, "Delay in 327 State Projects Cost Rs.54,717 cr," December 17, 2009, at *http://economictimes.indiatimes.com/news/economy/infrastructure/Delay-in-327-state-projects-cost-Rs54717-cr/articleshow/5347974.cms* (March 10, 2010).

incentives. Yet estimates of foreign share run below 1 percent.[7] The Indian infrastructure effort is gigantic—if there were money in it, multinationals would be knocking down the door.

More important, it was not infrastructure spending that pulled India out of the 1990 payments crisis and speeded its development; Deng Xiaoping did not launch the Chinese economy into a new era in 1979 with infrastructure. Sustained high growth can come only from market-oriented reform.

From 2004 to 2007, the excuse was anticipated political battles over market reforms that were never even crafted. Then reform had to be delayed due to the financial crisis. Now Congress's political position is stronger and the government sees world-beating economic performance, yet reform is again conspicuously absent.

The state has long intervened in education, banking, health, steel, and many other sectors. Just in the last few weeks, privatization was again explicitly disavowed. In contrast, trade protectionism and government distortion of the rural economy are on the rise. Populism is politically expedient and even morally appealing, but it is unsustainable. Asserting that the success of 1991–2007 will continue for a generation will not make it so, especially when Congress is charting a course back to the pre-reform era.

BIT to the Rescue? A prosperous India for the long term is manifestly in America's interest.[8] The U.S. certainly cannot change fundamental Indian policy. But improved economic relations can enhance the incentives for India to adopt more market mechanisms.

In the new U.S.–India Economic and Financial Partnership, the Department of the Treasury should therefore consider how to entice India to return to a market economy path. In the same vein, talks on a bilateral investment treaty (BIT) should be understood in part as a potential American contribution to active Indian reform.

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7. Arun S. "Foreign Equity Minuscule in Public-Private Projects, The Hindu Business Line, December 25, 2009, at *http://www.thehindubusinessline.com/2009/12/25/stories/2009122553300100.htm* (March 10, 2010).
8. Lisa Curtis, "Building a Strategic Partnership: U.S.–India Relations in the Wake of Mumbai," testimony before Foreign Affairs Committee, Subcommittee on the Middle East and South Asia, U.S. House of Representatives, February 26, 2009, at *http://www.heritage.org/Research/AsiaandthePacific/tst022609a.cfm.*