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India: Fast Growth Does Not Mean a Strong Economy

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For reasons ranging from geopolitics to poverty alleviation, a strong India is good for the U.S. India's strength will depend in great measure on the vibrancy of its economy. A complete picture of how the Indian economy is faring is therefore indispensable. It turns out India's recovery from the crisis is partly illusory—its growth is not sustainable and is not creating broad prosperity.

False Goals. India's GDP growth weakened immediately after the fall 2008 financial crisis but was nonetheless one of the world's best performances. It has now returned to the pre-shock 8–9 percent and remains one of the world's best performances. For the April–June quarter, India just reported that real GDP growth (using factor costs) was 8.8 percent.

There is discussion now of growth accelerating further to 10 percent. Domestically, rapid economic growth is supposed to be the cure for widespread poverty, among other things. Internationally, such growth is to herald India as the next global growth story. It will likely do neither.

Indian growth, driven for more than a decade by market reform initiated in 1991, is now being achieved the old fashioned, unsustainable way: through intense fiscal and monetary stimulus. Growth thus stems in part from New Delhi deliberately choosing to risk high inflation. Inflation is a tax that erases apparent wealth gains and redistributes income, hurting the poor in particular.

Irresponsible Stimulus. Growth anywhere in the 8–11 percent range is fast but unsurprising for

India at the moment. This is not because of India's genuinely high growth potential, which features demographic expansion and strong consumer demand. Rather, the fast growth is unsurprising because it is the result of both fiscal and monetary hyper-stimulus.

Fiscal stimulus gets the attention. Last fiscal year, the federal deficit was close to 7 percent of GDP. It is projected to fall under 6 percent this fiscal year and will do so due to one-time gains. There is no indication of spending restraint; in fact, quite the opposite. Long-overdue reform of the direct tax code was gutted in large part to support continued increases in federal spending.

In the same way, critical changes to the goods-and-services tax have been delayed and limited due to the desire of state governments to spend more. State government deficits pushed the consolidated national deficit past 11 percent of GDP last fiscal year and will push this year's deficit close to 9 percent of GDP.¹ The level may rise again next year. It is not surprising, nor sustainable, that government spending far outstripped private consumption April–June.

Monetary policy is worse. There is an ongoing debate over whether interest rate increases are com-

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ing too fast. This borders on ludicrous. India has large negative real interest rates, a terrible financial distortion by any standard. The Reserve Bank of India's (RBI) August hike brought the rate at which the central bank lends to banks to 5.75 percent. This left the real price of loans, after inflation, over negative 4 percent, a perverse incentive to borrow as much as possible.

Yet government and businesses complain that RBI is being too aggressive by modestly raising the world's lowest real borrowing costs. Because RBI is not fully independent, negative real rates should be expected to persist—the federal government needs low interest rates to keep its own borrowing costs low. With this amount of combined stimulus, it is no wonder growth is rapid and likely to remain rapid for several more quarters.

As it stands, though, rapid GDP growth will not last. RBI documents large productivity gains in the initial reform period (1992–1997) but weaker gains since.² The results are declining returns to investment and a blunting of benefits of demographic expansion. Lack of reform ensures more such weakness, and the ruling Congress Party has chosen to emphasize liquidity and spending rather than reform. For a while, quantity can replace quality, but economic performance must eventually suffer.

Encouraging Inflation. The government tries to stimulate the economy through spending but undercuts that through inflation. Inflation is an unfair tax. Among other things, it punishes those who put money away for the future by eroding their savings. More broadly, it harms certain asset holders and sectors of the economy and (comparatively) rewards others without any connection to behavior or scarcity. It thus undermines efficiency, inhibiting long-term growth.

In India, the primary impact of recent high prices has been to harm the poor, whose income largely goes to necessities. Food inflation stood at 14.6 percent at the end of the April–June quarter. While this has eased into the 10–11 percent range, fuel and power inflation was 14.3 percent at the end of June and may be accelerating. Asset prices are also rising because the cost of holding cash is so high. And the Ministry of Commerce continues to revise all old inflation figures higher so that previous harm was repeatedly understated.³

The government's response to painfully high prices has been to pretend they will go away soon. In autumn 2009, the government claimed that consumer inflation would dampen before spring 2010. Instead, wholesale inflation joined consumer inflation in double digits. In February 2010, Prime Minister Manmohan Singh indicated the worst was over, a claim later echoed by Finance Minister Pranab Mukherjee and others.⁴ This also turned out to be false.

The failed promises have continued for almost a year. Eventually, the government will be right—but only because a higher base from the previous year will cause inflation to fall. Lesser amounts of inflation still mean that prices are rising, and rising from a far higher base. Substantial inflation can be anticipated for some time because monetary policy, in the form of the large and negative real interest rates, continues to be so irresponsible.

Finally, the situation may be worse than it appears. Incomparable inflation indicators—weekly wholesale prices versus monthly consumer prices and so on—lead to confusion. The recent GDP announcement originally contained a sizable error due to an incorrect price comparison. It is possible that the most important inflation measurement, the GDP deflator, has been persistently underestimated

1. *The Financial Express*, "Gross Fiscal Deficit of States Set to Turn 3.2% of GDP," February 23, 2010, at <http://www.financialexpress.com/news/gross-fiscal-deficit-of-states-set-to-turn-3.2-of-gdp/582996> (September 1, 2010).
2. *The Economic Times*, "Reforms Haven't Helped Productivity, Says RBI," August 25, 2010, at <http://economictimes.indiatimes.com/Indicators//articleshow/6429760.cms> (September 1, 2010).
3. Da Yan, "India Inflation Rises to 10.6 Percent in June," Associated Press, July 14, 2010, at <http://www.businessweek.com/ap/financialnews/D9GUOHF81.htm> (September 1, 2010).
4. Subodh Varma, "Predictions on Price Spiral Way Off Mark," *Times of India*, July 29, 2010, at <http://timesofindia.indiatimes.com/india/Predictions-on-price-spiral-way-off-mark/articleshow/6230679.cms> (September 1, 2010).

in the reform era. If so, real GDP growth, which is corrected for inflation using the GDP deflator, has been overestimated for nearly two decades.⁵

Indian GDP adjusted for purchasing power is fourth-largest in the world, more than three times nominal GDP. But the adjustment for purchasing power is going to shrink—and measures of the economy with it—due to Indian inflation being much higher than the rest of the world's. This is another sense in which real income growth is being exaggerated.

The U.S. Can Help. The Indian government has opted for high growth and high inflation. There are other paths featuring market-oriented reform rather than hyper-stimulus that would yield high growth without the inflation tax.

There was lost opportunity to use the recent telecom bandwidth auction not to maximize government revenue but to promote quality, jobs, and growth in a critical industry. A much broader step that still can be taken is to end government discretion to seize land by assigning specific and transparent rural property rights. In 1980s China, this produced high growth and poverty alleviation. It could do the same for India.

Inflation, government waste, and other failures should be enough to convince India to turn away from state-led development. If India resumes in earnest the market-oriented reforms begun to such great effect in 1991, the U.S. can help in the following ways:

- The Departments of State and Agriculture should offer in the U.S.–India agriculture dialogue technical assistance in promoting rural property rights;
- The new India–U.S. Financial and Economic Partnership should focus on cooperation in unwinding mutual fiscal and monetary stimulus; and
- The U.S. should refrain from its own intervention in U.S.–India commerce, such as recent congressional action to target visas for Indian workers.⁶

Not a Sign of Prowess. India's present growth is not a sign of economic prowess; it is a choice most countries do not make because the concurrent high inflation typically targets the poor.

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5. A. Srinivas, "Questioning the Growth Numbers," *The Hindu Business Line*, February 25, 2010, at <http://www.thehindubusinessline.com/2009/02/25/stories/200902250451700.htm> (September 1, 2010).

6. Derek Scissors, "The Wrong Way to Deal with India," *The Foundry*, August 9, 2010, at <http://blog.heritage.org/2010/08/09/the-wrong-way-to-deal-with-india> (September 1, 2010).