INDIAN ECONOMY: SHOOTING STAR OR GROWTH STAR (HGE)?[1]

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1 INTRODUCTION

[1] An outline of this paper was presented as a talk titled "Equity, Growth and Policy Change" presentation at the seminar on 'Emerging Challenges: Will India continue the growth momentum?" at PHD Chamber of Commerce & Industry, New Delhi on November 17, 2011. https://sites.google.com/site/drarvindvirmani/talks.

The economic reforms of the 1990s raised the growth potential of the Indian economy and put it on a higher growth path (Virmani(2009)).[2] The economy consequently entered a third growth phase in the 1990s, after initial hiccups (J curve of Growth).[3] Based on the post war history of economic growth across the World and given the backdrop of the US-Global financial crisis of 2008, Virmani (2009) and Economic Division (2009) warned that higher growth potential does not ensure higher actual growth.[4] Because of the complacency induced by the V shaped recovery in India and across the World, these warnings were barely noticed by the economic actors, the organs of government, academics, columnists and the media.[5] Unfortunately the worst fears seem to have come true, with an extended period of high inflation and declining growth rates.

However, all is not lost! Given the underlying strength of the Indian economy there is still time to put the economy back on track to a sustained growth rate of 8.5% to 9%. This requires a removal of the various bottlenecks that have arisen and the stimulation of new drivers of non-inflationary and equitable economic growth. If this is not done, growth will slow to the point that it will be impossible to support all the new social programs that have been initiated or expanded since 2004. Slowing growth and reduced expenditure will not only have a negative effect on social welfare but could also have grave political consequences! This note tries to analyze from a policy perspective, the problem and solutions to this problem.

The next section discusses the lessons of high growth economies (HGEs) that have sustained growth for a long enough period to move from low income levels to high or upper middle income. Section 3 looks at the Global financial Crisis and its current manifestation the Euro crisis and draws lesson for emerging markets including India. Section 4 examines the Indian economy, its possibilities and problems. Section 5 lays out the key reforms that are needed to put the Indian economy back on the high growth track.

2 HIGH GROWTH ECONOMIES (HGEs)

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[2] Virmani (2004) showed that there were two stages in the growth history of India between 1950 and 1991 and Virmani (2005) predicted that the 1990s economic reforms would put the economy on higher growth path.

[3] See the appendix of Virmani and Hashim (2011), for a summary of the J curve hypothesis.

[4] For recent warnings see blogs at http://dravirmani.blogspot.com/ including, http://dravirmani.blogspot.com/2011/09/sudoku-of-indias-economic-growth.html and http://dravirmani.blogspot.com/2011/08/socio-political-warning.html.

[5] Except for the period succeeding the presentation of the Economic Survey of 2008-9 and the succeeding Budget, when the then chief economic advisor gave a series of interviews explaining and expanding on these fears and what needed to be done in the next five years to sustain growth.

One of the most striking facts about economic growth is that many countries have had episodes of high growth (average of five years or more) but very few countries have sustained high growth for a decade or more. For simplicity we can call the former 'Shooting Stars' and the latter 'Growth Stars' or High Growth Economy (HGE). Growth researchers first observed this in the 1980s by looking at the average growth rate of all countries by decades and then measuring the co-relation between their growth rates across decades. Using the latest available cross country data, we find very little correlation between countries that grew fast in the last decade (2000s) and either the decade of the 1990s or that of the 1980s. Out of 190 countries for which data is available for varying periods up to 50 years, there have been only eight countries that have averaged a growth rate of seven per cent or more for over two decades and another twelve that have grown at this rate for fifteen years.

Table 1 presents a correlation matrix for average per capita GDP growth per decade across countries for five decades from 1961 to 2010. This correlation has been is about 37% across two contiguous decades till the latest decade when it was reduced to 0.04 (table 1). In other words there is no correlation between countries that grew fast during the decade of the 2000s (2001 to 2010) and the previous decade of the 1990s (1991 to 2000). The growth correlation across two non-contiguous decades has also decline from about 1/3rd (decade of the 1990s and 1970s) to a 1/10th.(decade of 2000s and 1980s)

Table 1: Decade Average Per Capita GDP growth - Cross correlation

	1960s	1970s	1980s	1990s	2000s
1960s	1.00	0.35	0.34	0.18	-0.13
1970s	0.35	1.00	0.37	0.31	0.10
1980s	0.34	0.37	1.00	0.37	0.12
1990s	0.18	0.31	0.37	1.00	0.04
2000s	-0.13	0.10	0.12	0.04	1.00

Source: Author's calculations based on data from WDI 2010 (augmented by data from IMF WEO October 2011 data base).

2.1 Growth Stars

We can define HGEs as countries that had an average growth rate of per capita GDP of 7% or more, for a contiguous period of 10 years or more. This would mean that their per capita GDP doubled during the decade. There have been, since 1960, only six medium large countries (GDP PPP > $40 bi in 2008) that have grown at an average rate of 7% or more for over two decades, quadrupling their per capita GDP over these two decades. There were another 17 medium-large countries that have averaged a growth of per capita GDP of 7% or more for over a decade, of which only 5 sustained this for 15 years or more.[6] Among these Oil/energy has made a significant contribution to growth in

[6] Of the 17 three had highly volatile growth rates, with standard deviation more than three times the average growth rate of per capita GDP, over the 50 years.

four-five countries (Oman, Angola, Saudi Arabia, Iran and perhaps Syria). Out of the remaining 18 countries half are Asian (China, Singapore, Hong Kong, Myanmar, S Korea, Japan, Thailand; Azerbiajan, Kazhakstan, Lebanon). Interestingly a majority of countries that have sustained high growth for long enough to go from low income levels to upper middle or high income levels have been in Asia.[7]

Table 2: No of High Growth Economies by years of high growth
(HEG = Average growth of 7%+ for 10+ years)

Economies [Years =>	10 to 14	15 to 19	20 to 29	30 to 50	≥ 10
Medium-large HGEs	12	5	3	3	23
	(4/)	(3/)	(2/)	(1/)	
Small-tiny HGEs	12	7	2	0	21
All HGEs	24	12	5	3	44

Notes: 1/ China, Botswana, Oman. 2/ Singapore, Hong Kong, Myanmar. 3/ S. Korea, Azerbaijan, Japan, Belarus, Angola. 4/ Greece, Thailand, Portugal, Lithuania, Kazakhstan , Iran, Saudi Arabia, Brazil, Syria, Russia, Ukraine, Lebanon.
Source: Author's calculations based on data from WDI 2010 (augmented by data from IMF WEO October 2011 data base).

2.2 Potential Growth Stars

Though India is not among the current HGEs it is a potential HGE. We can define 'potential HGEs' is as countries whose per capita GDP has grown by an average of 6% per cent or more for at least a decade. These countries have the potential to increase their per capita GDP growth to become HGEs. There are 13 medium-large countries that satisfied this criteria for the period of our analysis.[8] Among these Oil/energy has made a significant contribution to growth in Algeria and perhaps Sudan, Nigeria and Cameron. Of the remaining nine about half were in Asia (India, Malaysia, Vietnam, Indonesia). India with an average growth rate of about 6.5% during the decade ending 2011, was number two behind Ireland (6.8% growth) among this (non-oil) subset of potential growth stars.[9] The fact that India's GDP has grown by an average of 7.1% per annum over an 18 year period to 2011 of which there were 10 years of over 7% growth, gives us additional confidence that India is a 'potential growth star'.[10] However, potential does not necessarily translate into actual, unless the lessons of sustained growth are learned and

[7] There are a large number of countries from the former USSR among the HGEs, most of which were lower middle income countries before their growth spurt!
[8] There are also 11 small-tiny economies or territories.
[9] It was number four among all medium-large potential growth stars. In contrast to India the other three countries have had highly volatile growth rates since 1960, with a standard deviation more than three times the mean of the Per capita GDP growth rate.
[10] Over this 18 year period its per capita GDP growth averaged 5.5% per annum.

applied. In this context the lessons from the 'non-oil/ energy/natural resource rich' HGEs and 'potential HGEs' in Asia are particularly relevant to India.

2.3 Sustaining Growth: Lessons

What do we learn from those countries that have shown such Sustained Growth, particularly those whose growth has not been driven substantially by oil production or other natural resources? The policy changes needed for raising growth are different from those for sustaining it. Countries that respond actively and consistently/persistently to remove bottlenecks (as they arise) and deal with the negative effects of exogenous shocks (foreign and domestic) continue to grow! Successful approaches to reform have been pragmatic (what works/what doesn't), non-ideological (as against abstract or philosophical). Big bang reforms are useful for raising growth potential but not necessary for sustaining growth at high levels. What is needed is a steady stream of reforms for removing bottlenecks as they arise/come into view, stimulate new growth drivers when old ones are exhausted and initiate institutional change as old institutions are unable to cope with the demands of more modern, higher income economy.

3 FINANCIAL CRISES: COMPLACENCY

When the financial crisis struck the US and World exports and industrial production crashed during the second half of 2008, the World stood at the abyss of a second great depression. Fortunately, quick and effective fiscal and monetary policy loosening by virtually every large economy resulted in limiting the fall and induced a V or U shaped recovery in 2009-10 (in terms of production in the advanced countries and in terms of growth in the Emerging economies). This in turn induced a misplaced confidence in the resilience of each economy among economists and informed public opinion, and engendered a sense of complacency in governments and political establishments across the world. This resulted in the neglect of basic economic reforms that were essential for restoring economic growth to its full potential, both in countries where the crisis originated and in emerging economies that suffered collateral damage from this "great recession".[11]

With underlying problems remaining unresolved, political gridlock in the USA and the Euro-area countries triggered "Stage 2" of the financial crisis in the middle of 2011.[12] Since then the risk of other financial crisis, this time originating in the Euro area have increased significantly. Consequently the rest of the world, including India and the other emerging markets face a high risk environment that is likely to persist for some time. Despite a sharp growth slowdown in the BRIC economies including India, they and other Emerging economies still have policy, regulatory and institutional reform choice that they can make to sustain growth.

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[11] Arvind Virmani, "Real Issues vs. Straw Men", Policy Paper No. WsPp2011/ 2, June 2011 https://sites.google.com/site/drarvindvirmani/policy-papers.

[12] http://dravirmani.blogspot.com/2011/08/financial-crises-stage-2.html and

3.1 Lessons of Fiscal Crises

In this sub-section we digress briefly to draw the lessons from the fiscal crisis in three advanced economies, namely the USA, Italy and Greece. Each has something different to teach Emerging economies like India, which have relatively high fiscal deficits.

The USA is an example of a country that has failed for decades to confront long known fiscal problems. The un-sustainability of the Social security and Medicare system have been known for years and been analyzed by economic experts who have suggested a range of reasonable solutions. Instead of doing something, the political system kept postponing action on the underlying problems of Social Security and Medical care that were seen as long term ones that could be tackled at some future date. Despite this, a new democratic administration, converted deficits (1993) into a surplus by 1998 and maintained it there till 2002, through a moderation in expenditure growth coupled with higher GDP growth. Then the next administration through a series of Tax reductions and increased expenditures on 'Wars of choice' converted it back to a deficit in its first year (2003) and laid the basis for an explosion in government debt when the bubble burst and automatic stabilizers kicked in during the 'Great recession.' By the time the problem was finally appreciated by the public and the political system, political gridlock within and among the two parties made it virtually impossible to do anything about it, resulting in the first sovereign rating downgrade in modern US history.
Moral of the Story: Slow and steady progress can be helpful if you maintain fiscal probity through changes in government. More important, find structural solutions when the economic and political situation is good or you may end up in a situation when both are bad and you can't do anything to stave off crisis.

Greece

When Greece joined the Euro its real interest rates declined and growth accelerated (largely as a consequence of becoming a member of a currency union). Instead of using this as an opportunity to reduce sovereign debt, the political system saw this as an opportunity to spend even more. Thus the fiscal structure deteriorated during the boom years with the result that when the bust came in the form a of a European and global recession, the fiscal problem was unsolvable and default inevitable.
Moral of the Story: Advice on fiscal probity sounds absurd and unbelievable when the going is good. It is hard to predict the timing of fiscal crisis and it will hit you when you least expect it. Fiscal sustainability depends on medium-long term growth rates and real interest not on short term ones and it is often difficult to derive the former from the latter. So it is best to use any opportunity that arises to put the fiscal system on a sound long term basis, instead having to do it under the gun of financial markets.

Italy

For the last four decades or so Italy's average growth rate has been declining by about 1 % point per decade to 0% in the last decade. Instead of solving this problem of the trend decline in economic growth, the political system was more concerned with preserving the subsidies going to each party's supporters. Despite this, one government did succeed in lowering the fiscal deficit substantially in 1994. However, the success proved temporary as a change in government led to a re-intensification of the political struggle to protect and enhance subsidies for own party supporters. Sovereign debt had therefore again exploded by 2001 and was uncomfortably high when the Euro crisis hit last year. With growth virtually nil (or perhaps negative for some time), even a modest interest rate requires a substantial Primary surplus. Further any rise in the risk premium (due to fears about Greece etc.) requires very painful contraction.

Moral of the Story: Do not take growth or the revival of growth for granted. Fundamental structural reforms need to address both medium-long term growth and fiscal deficits/debt.

4 DOMESTIC ENTREPRENUR LED GROWTH

4.1 Potential Growth

Few economists had predicted that as a result of the economic reforms during the 1990s, the growth potential of the Indian economy would rise significantly above the 5.5% to 5.8% average of the second stage of growth from 1980-81 to 1991-2 (Virmani(2005)). Till 2006, most academics and analysts were puzzled by the fact that the growth rate of the economy appeared to have remained virtually unchanged after the 1990s reforms! We had postulated that there was a "J-curve of Growth and Productivity" arising from the dynamics between the negative and positive impact of reforms, as a result of which the acceleration of economic growth may take some time to materialize (Virmani (2005), 2006a b c)). It was only post- 2007 studies, which confirmed that Indian growth accelerated from 1992-93 and India entered the third more elevated stage of its growth history, following the 1991-1992 reforms (Virmani (2009) and Virmani and Malhotra (2010)).

Growth averaged almost 9% during 2003-04 to 2007-08 and averaged around 8.7% during 2003-04 to 2010-11. In per capita terms this translates to a growth rate of 7% plus, a rate at which per capita income would double every decade. Even though we have grown at over 7% for more than a decade in terms of GDP, we have still not completed one decade of Per Capita GDP growth of 7% to become a High growth economy (HGE)! Consequently, Virmani (2009) and the 2008-9 Economic survey warned of complacency [Economic Division (2009)].[13]

4.2 Actual Growth

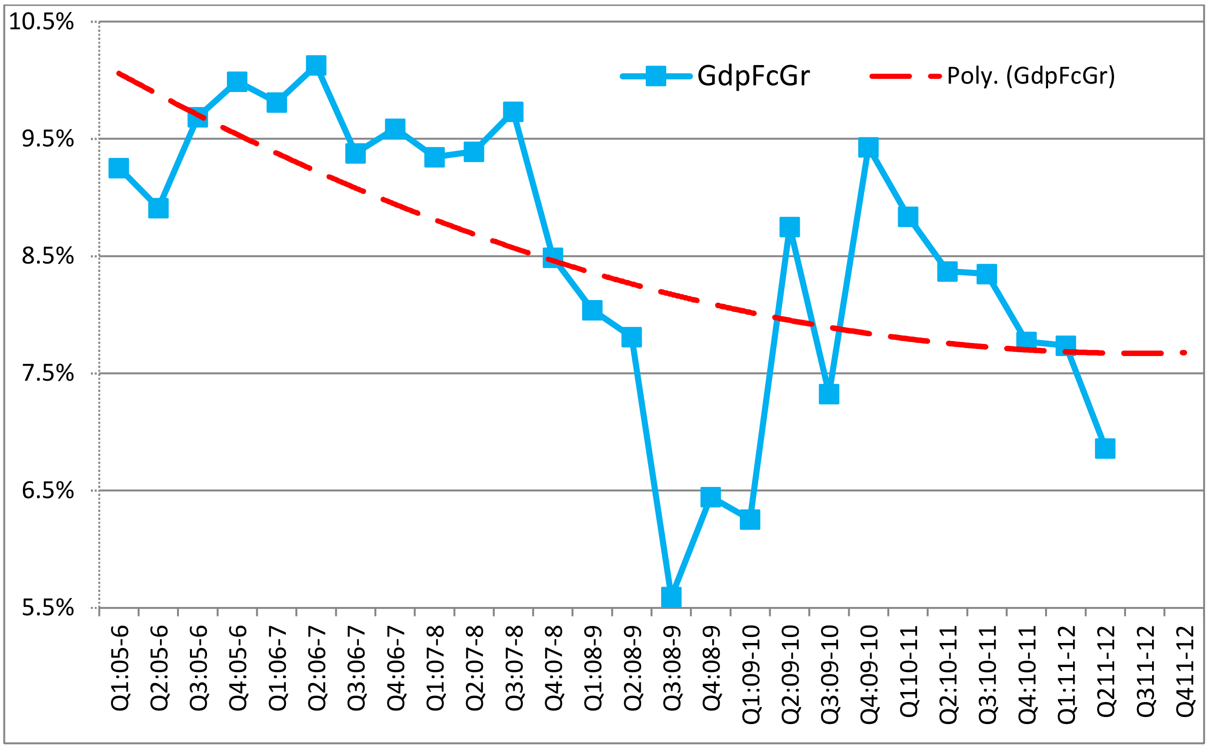
Economic Growth has been on a declining trend since around the first quarter of 2005-6 (figure1). Growth has slowed dramatically in 2011, with GDP growth in the

[13] As the author has made clear in numerous interactions with the media, speeches and in writings since 1995, the 1990s reforms raised Growth Potential of India to 8.5% to 9%.

second quarter of 2011-12 falling below 7% and industrial production in October 2011 declining below what it was a year ago. This is due to a combination of shocks, cyclical factors and 'below trend' economic policy and regulatory reforms since 2007. The shocks emanating from the Euro-crisis acted as a trigger, coming as they did on top of the continuing effects of the global financial crisis that started in 2008. These shocks and cyclical factors such as monetary policy have pushed growth below even this declining trend. Once monetary policy is adjusted to take account of below trend growth and temporary shocks disappear, growth will return to this trend. However, the down trend in growth below its medium term potential will not reverse unless determined, coherent and consistent policy reform action is taken. From the economic perspective it is still possible to reverse the declining trend.

Pessimism would only be justified if we are convinced that the political gridlock within and between major parties cannot be broken. I am personally still extremely hopeful that a consensus can be built to put reform back on the steady track needed to address known bottlenecks and negative effects of shocks in a timely manner and to sustain growth at 8.5%.

Figure 1: Rate of Growth of GDP at Factor Cost (2004-5 prices)



5 REMOVE BOTTLENECKS, PROMOTE GROWTH DRIVERS

Policy and regulatory reforms are urgently needed to put Indian growth back on its potential medium-long term trend rate of 8.5% to 9%. Imaginative policies that promote equity and growth and reduce rents (i.e. opportunities for corruption) are the need of the hour. I have picked issues that are of both short and medium term nature, in which it would not only be helpful to do something now but will also need determined action over the medium term to have a permanent and sustained effect on growth and equity.

5.1 Oil/energy

Problem: Oil and energy import dependency is high and increasing, implicit taxation-rent transfer to foreigners, which makes the people of country as a whole worse off; Long term price trends are adverse and problem likely to get worse unless policy reforms are instituted.

Solution: Separate and disconnect subsidy from pricing. Replace Kerosene subsidy with free solar lanterns and cookers. Provide free training to village youth to service these items in rural areas. Replace Diesel subsidy with subsidy for fuel efficient engines of all kinds (pump sets, generator sets, tractors, trucks). Give subsidy for adoption and development of new technology. Allow prices to reflect the global price of all energy items.

Promote *Green Cities*: Get the world's best designers and architects to come and design green buildings etc. suited to Indian climatic conditions (water, heat etc.), construction materials and construction methods. Publish and propagate these designs. Train urban planning and regulatory officials in every State.

5.2 Food Prices and Policy

Problem: Historically food inflation generally goes up following a bad monsoon and returns to normal rates following normal monsoon and the restoration of agricultural production to its trend growth of about 2.5% per annum. This time around higher food inflation rates seemed to have persisted for an inordinately long time. What has changed?

On the domestic side there are three significant changes that I had identified in 2008-09. One is the doubling of the rate of growth of per capita income and its impact on growth of demand for food; Second is the boom in urban land prices and consequently on real estate prices and rents. The third is the increase in fuel prices and its effect on transport costs. The first and third would tend to increase the cost of food at all levels and the the second would tend to increase the gap between the retail and wholesale levels. The small fragmented supply chains cannot cope with the increased demand for basic and new higher level foods. We need a revolution in the food supply chain - particularly fresh foods (from farm to retail). Government's decades old plans for cold chain, package of inputs, credit, output markets have not worked, given the institutional setting and context that exists. In fact the institutions have in many cases deteriorated relative to what they were 20-30 years ago, so that they are not able to cope even with normal increases, let alone unprecedented ones.

Solution: Try what worked elsewhere – Competition through FDI in grocery retail.[14] The entry of domestic large retail suppliers has made some difference a few products and geographies. We need a (food) retail revolution, to cope with the increased challenges. Opening of FDI in retail is the only solution we have not tried. This needs to be complemented by reforms of the Agricultural Produce Marketing Acts (APMs) and the Essential Commodities Act (ECA), for farmers to get the full benefit of increased competition.[15] We also need a more predictable import-export regime for farmers that balance the needs of consumers and farmers on a permanent basis rather than lurching from season to season from one extreme to the other. The economic survey of 2007-08, proposed price bands with variable import tariffs and export duties outside band. This would mitigate the effect of extreme high prices on consumers and of extreme low prices on farmers, while ensuring that the latter receive the right price signals to promote productivity and growth of production.

5.3 Urban Poverty/ Wealth gaps

Problem: The basic most visible manifestation of the Urban problem is the Stratospheric price of land, equaling or exceeding that of countries that have more than 10 times our per capita GDP. This is due to the acute shortage of "urban land", public transport (in metros) and basic urban public goods (water, sewerage, drainage, sanitation, durable roads, primary education outcomes, public knowledge of nutrition and hygiene). The gap between demand and supply of urban land has started increasing rapidly since the rate of per capita GDP growth accelerated. The wider the gap, the sharper the effect on wealth inequality and more the opportunity for rent seeking and corruption! Only by increasing dramatically the supply of habitable and accessible urban land can we help the low income residents, reduce urban wealth inequalities and minimize corruption.

Solution: Reform urban governance through genuine decentralization from State governments to the city governments and modernize laws, policy and procedures for specifying / changing land use and for sale of land (through competitive auctions). This requires measures additional to the Land acquisition and Relief and Rehabilitation laws.

5.4 Mobility/Equality of opportunity

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[14] Because of local and regional tastes, there is a stronger inherent/natural incentive for large marketers to build domestic supply chains for food/grocery items. Thus it may be better to focus initially on allowing 74% FDI in grocery/food retail as against 51% FDI in general retail (including grocery), if the primary objective is to build an efficient food supply chain that benefits farmers and consumers.

[15] E.g. delisting of perishable commodities like fruits and vegetables and new nutritional items like soya, from schedule 1 of APMC Acts. For poorer/less developed States/regions to benefit fully we also need a road grid connecting every village and a sustainable water/irrigation grid in every block.

The demographic dividend can only be actualized by providing usable skills built on sound primary education (fraction of secondary school students can read at primary level). A fast growing lower middle income economy like India's needs intermediate skills in all kind of services. This scale of the opportunity/problem is enormous. Govt. must do whatever it can within its institutional capability and resources. We should encourage all other sectorys (NGOSs, Private) to make whatever contribution they can. Let a hundred flowers bloom under a sound regulatory framework that helps trainees understand what they are paying and what they are getting.

5.5 Rents and Corruption

Rent Sucking (Rent creation and rent seeking) is the greatest source of inequality in income and wealth. There are three major sources of rent that need to be addressed.

(a) Natural resources (minerals, land, spectrum)
Solution: Auctions with tradability; Sound regulations and regulatory system.

(b) Land Use
Solution: Land use hearings & appropriate change of land use based on these hearings, before acquisition starts. Once this is done market price will reflect the true value of the land as long as government makes the information available to all land owners and potential land acquirers.

(c) Government Procurement/Contracting
Solution: Public Accountability Information System (PAIS), that insures that all information is put on a web site accessible to the public. This would include the nature and scope of job/purchase, amounts paid and to whom.

5.6 Macro economics

5.6.1 Fiscal-Monetary Mix

Since the V shaped recovery in 2009-10, Indian macro policy would have produced better results if the Fiscal policy had been tighter and monetary policy looser. This remains true today.

5.6.2 Fiscal Deficit Target

Target zero fiscal deficit over a realistic time frame. This is essential for bringing down real long term interest rates to international levels, stimulating domestic investment and reducing dependence on unstable capital flows. Government's ability to deal with Global adverse shocks and exploit new opportunities would be greatly strengthened.

5.6.3 Financial

Accelerate developments of Long Term Debt markets to reduce dependency on volatile capital flows.

5.6.4 Infrastructure

Policy-regulatory regime that promotes *competition* in 'private goods infrastructure', e.g. Coal, electricity generation, rail services. Coal fields should be parceled into economic and viable mines and auctioned to a dozen producers (PSUs should also be permitted to bid in auctions).

The simplest, most effective way to promote inclusive growth is by building a permanent road network that connects every habitation in India, a drinking water and sewage/sanitation grid that services every town and an irrigation-drainage (water sustainability) grid covering every block/village.

6 CONCLUSION

There is a significant probability of a Euro melt-down in the next 12 months. Emerging Market Economies, including India have the policy space and ability to minimize the effect of the continuing global financial crisis on their economies and resume/sustain growth at close to its potential in each country. This requires urgent policy actions to remove bottlenecks to growth, eliminate rents, and facilitate removal of supply constraints. This policy note outlines a range of policy actions that can help in restoring India's growth to its underlying potential of 8.5% to 9%. Some if not all these policy reforms may require a reorientation/adjustment of the approach to political cooperation and competition.

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