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A New Strategy to Revive India's Economic Growth

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Abstract

The author joins the debate on what has caused the Indian economy to stumble over the last few months and what can the policy makers do to revive growth in a way that it can be sustained over time. It can be argued that the economy's wounds are self-inflicted. In the author's view, India's policy makers – not just those who currently hold the reins of power but also those who come after them – must bring about a fundamental change in the Indian economic strategy.

Bad News about the Economy

Bad news has come out of New Delhi in recent days. On 30 August 2013, the Government released a report on the performance of the economy for the quarter ending 30 June. The Government waited until the stock and financial markets were closed to announce that the economy expanded by 4.4 per cent, well below the economists' projection of 4.8 per cent. Manufacturing and mining were hit the hardest. That the authorities waited until the close of the markets to release this news was another indication of their nervousness. That the policy makers are extremely anxious and fear the reaction of the market had the opposite effect. It further eroded confidence; and, as economists have pointed out for years, nothing hurts the

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economy more than loss of confidence. The real challenge before the policy makers is to restore faith in the economy's future particularly in the foreign markets. This is important for India because the country, unlike the miracle economies of East Asia, depends on external capital flows to finance its fairly large current account deficit. In recent months most of these flows were short-term, destined towards the capital markets. This type of flow is very susceptible to the way the markets read the economy.

Mistakes in Handling the Weakening Economy

In dealing with the crisis the policy makers have made two major mistakes. They have decided that they must worry more about the rate of inflation that, according to their reading, remains stubbornly high. To bring it down they have decided to use monetary policy to curb demand. This Friedman-like approach was taken because of lack of confidence that the managers of fiscal policy in New Delhi will be able to use their powers to affect demand. But this approach begs two important questions. Is the rate of inflation really high and should the monetary policy go in the direction in which it is proceeding? The answers to both questions are "no".

The monetary authorities focus more on the consumer price index, the CPI, to fashion their policy response. They don't use the Gross Domestic Product (GDP)-deflator since it appears with a time lag. Those who manage the monetary policy don't like to wait for too long before they act. The CPI and the GDP-deflator usually move in tandem, unless some sector in the totality of national product sees a significant increase in its value-add. This has happened in recent times when the contribution of agriculture, expressed in nominal terms, far exceeded its contribution to GDP. This divergence was caused by a significant increase in the Government's procurement prices. The increase in the prices of the commodities, in administering which the Government plays an important role, was mostly resorted to for political rather than economic reasons. This pumping of money into the rural economy caused prices of food items to rise and contributed to the increase in CPI and resulted in the policy makers becoming nervous. Their anxiety led to the tightening of domestic money supply. This response to the economic crisis was the opposite of what should have been done. India needs more investment in the economy rather than less. Given the strains on the fiscal side, a Keynesian approach cannot be adopted. The real option is to stay with monetary management to fine-tune the economy.

While this was happening, the authorities responsible for budgetary matters entered the picture but on the wrong side. They became Keynesian but for the wrong reason. They announced a massive increase in the programme to subsidise food for the poor, knowing full well that a significant amount of the resources thus spent would not reach the poor, the intended targets of the programme. If the authorities are aware of this – and there is no reason why they should not be, since research books in India are full of studies that have come to this conclusion – the real reason may well be that those in power want to keep on their side the real beneficiaries. Those who really benefit from the supply of subsidised food are the

tens of thousands of people responsible for handling it. They are probably an important voting bloc in a highly competitive political system. This is a highly cynical interpretation of this otherwise inexplicable move. The day the Indian Parliament approved the revised food subsidy programme the capital markets sank. They recognised that this was a massive mistake made by the managers of a troubled economy.

Move towards Low-Wage Manufacturing

There is one fundamental fact about the Indian growth story that must not be lost sight of as the policy makers now as well those who will assume power after the next elections address the problems that have surfaced in the economy. Unlike most other rapidly developing economies, India's growth spurt was not caused by a low-wage manufacturing sector producing for the export markets. It was the consequence of the remarkable performance of the information technology (IT) sector over the last decade and a half. With this sector, the Indians have begun to dominate some parts of the computing world. The success of this sector was followed by that of some other high-tech enterprises. India is now a world leader in the pharmaceutical industry and has captured a significant part of the generic drug market. These sectors powered the rest of the economy but in a limited sense. The main beneficiaries were the highly trained scientists who manned these sectors. Their earnings rose but their demand for goods, commodities and services was markedly different from the demand for items consumed by the masses. The multiplier associated with these sectors was small and restricted to the overall impact of the sectors in which they worked.

For India to be able to sustain a high rate of growth over decades, not just over a few years, it will have to develop an economy where the engine of growth comes from the activities that employ low-wage workers. In other words, the country should follow the model pursued with such success by the "miracle economies" of East Asia. There is an opportunity for doing that, since the manufacturing centres in East Asia have begun to see significant increases in their wage bases. The manufacturers who went to East Asia because of its low wages are now looking for other places. India could become the new destination.

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