

Secular Stagnation: Can India Buck the Trend?

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Introduction

India's GDP has grown at an average rate of over 6 percent per annum over the last 35 years, which would place it among a small elite group of high-growth countries.¹ Overall, the global economy had also done relatively well throughout this period up to the North Atlantic Financial Crisis (NAFC) which broke out in 2008. Global trade has also had a golden period of high growth. The most important question for India now is if we can join an even smaller elite by maintaining a sustained high growth path over the next three decades.

Such a question, if posed five years ago, would have elicited a definite “yes”. The situation now is different, but we still answer “yes” albeit with some uncertainty. In the advanced economies, the Great Moderation has given way to the Great Recession and now to the emergence of widespread concern about the initiation of a long period of secular stagnation in the advanced economies in general. What could have earlier been seen as a large cyclical downturn is feared by many as the precursor of a longer period of slow growth in the advanced world that could have repercussions on developing countries as well.

Coming back to India, despite the high growth of the last three decades, the per capita income of India remains low at around \$1500 per capita. Even if per capita income grows at around 7 percent per annum, it will only reach around \$6,000 by around 2035 (2011-12 prices and market exchange rates). Viewed in this context, India simply does not have the option of not aiming for high growth.

This paper provides one scenario that suggests that it is well within the realms of possibility for India

to achieve accelerated sustained growth of 8 percent-plus over the next 15-20 years, even if there is a sustained slowdown in much of the advanced world. But this is predicated on global trade recovering from the Great Recession slowdown, as a consequence of the greater weight of fast-growing emerging markets and developing economies (EMDEs) in the global economy. Mostly, it will take strong policy action by Indian policymakers, in terms of macroeconomic stability, particularly fiscal stabilization, and continuous structural action to stimulate high public and private investment. India has a demonstrated track record in both areas since the early 1980s, so there is some basis for optimism, although the institutional development and reforms now needed to move up the ladder towards upper-middle income status will be of a much higher order than those achieved in the past.

Can High Growth Be Restored in India? A Simulation for 2017-32

We start by analyzing India's recent growth slowdown, before turning to describe simulations for a return to rapid growth in the medium-term.

The Great Slowdown: 2012-14

The growth slowdown during 2012-14 occurred after almost a decade of consistent high growth, including a sharp recovery from the 2008-09 crises. The monetary and fiscal policy response to the NAFC was admirably rapid, but there was overshooting of the stimulus. This caused high but unsustainable growth—averaging around 9 percent—during 2009-11 and sowed the seeds for

inflation and current account pressures. Inflation is still to come down to the desired levels of 4-5 percent, and fiscal correction is a work in progress.²

The delayed and incomplete withdrawal of the fiscal stimulus led to crowding out of the private sector, which has also hampered private corporate investment. Simultaneously, high nominal interest rates in an environment of subdued growth also impacted corporate profitability and investment, which has suffered a notable slowdown. Moreover, the global environment has imparted headwinds: Growth in exports of goods and of services during 2012-14 was almost a third of that during the 2003-07 period. The strong boost to domestic demand during 2009-11 from the domestic stimulus led to widening of the current account deficit (CAD) from 1.3 percent of GDP in 2007-08 to 4.7 percent in 2012-13, clearly above desirable and sustainable levels. Finally, a key feature of the great slowdown is the near collapse of manufacturing growth in 2012-14, which has been near zero during this period—an almost unprecedented event for the Indian economy since independence.

A Simulation for 2017-32

Historically, Indian growth accelerations have been accompanied by higher gross domestic investment rates, largely financed from correspondingly increasing domestic savings.³ One scenario for significantly higher savings and investment levels, consistent with a return to 9 percent growth, has been released by the National Transport Development Policy Committee (NTDPC 2014) in its recent India Transport Report: Moving India to 2032. The simulations reported here are essentially taken from this report.⁴

The projections aim to provide a consistent macroeconomic framework for returning Indian annual GDP growth to around 7 percent in the near future and then ascending to 8-9 percent over the period 2017-2032. The objective is to work out the implications for the kind of movements that will be needed in key macroeconomic magnitudes

that would make such growth possible. The results then provide some assessment of the feasibility of achieving such a growth objective. This scenario entails the gross domestic capital formation (GDCF) rate to increase from about 35 percent in 2012-13 to around 39 percent during 2017-22, and further to 43 percent during the five-year period 2027-32. Such a projected increase in investment would appear to be achievable in view of the actual investment level of 38 percent reached in 2007-08. The corresponding rates of domestic savings would be about 36 percent during 2017-22, rising to 41 percent during 2027-32. These projections envisage an increase in all of the three major components of savings—household, private corporate and public savings. While the projections may seem ambitious, they appear to be reasonable and achievable, given that the domestic savings rate had reached almost 37 percent in 2007-08. In this scenario, the absorption of external savings has been kept at around 2.5 percent of GDP throughout the period, which is judged to be consistent with a sustainable CAD.

What do the projections imply for the overall efficiency of the economy? One crude measure of productivity is the incremental capital output ratio (ICOR). Indian ICORs have ranged between 3.5 and 4.5 for much of the past three decades, except for some outlier years. Our projections embedded in the desired growth paths of GDP and GDCF imply an ICOR of about 4.2 over the next couple of decades. We are therefore assuming a relatively high level of efficiency in resource use, but which is consistent with Indian historical achievements and hence in the realm of feasibility.

What would be the nature of sectoral growth transformation that would be consistent with projected GDP growth? A key feature of such a growth path is that, even with relatively optimistic agriculture growth scenarios of around 4 percent per year, overall GDP growth rates in excess of 8 percent are really not possible to achieve without manufacturing growth approaching 10 percent. Whereas such a high rate of manufacturing growth was indeed achieved during 2005-08, India has never exhibit-

ed such a rate over a sustained period of a decade. The revival of competitive Indian manufacturing over a period of a couple of decades is a key element of the scenario.

Financing Growth

Household savings have been the bedrock of domestic savings in India, exhibiting a steady increase over the years. They reached about 21 percent of GDP during 1997-2003 and ascended further to just under 24 percent during 2008-12. We have projected only a slow increase to about 28 percent by 2027-32, concentrated in household financial savings. These need to be restored to the earlier 10 percent level in the near future (from 7 percent at present), and then increase gradually to around 13 percent by 2027-32. This would appear reasonable with increased financial depth in the economy as income increases at the kind of pace projected; increasing shares of savings should go into contractual saving such as insurance, provident and pension funds as urbanization gathers pace and people have to insure themselves for their retirement. Ensuring positive real returns on deposits is necessary to reverse the downward trend in household financial savings, along with a focused thrust on contractual savings schemes. The vast majority of Indian household savers continue to exhibit a marked preference for safe savings avenues such as postal savings and public sector bank deposits.

All of this is predicated on the softening of inflation and inflation expectations in the country over the next couple of years. As persistently high food inflation has been a key driver of headline inflation, monetary policy will have its limitations. Accordingly, supply-side policies aimed at improving productivity and output in agriculture through reorientation of government spending away from current spending (fertilizer, power and irrigation subsidies) towards capital outlays will be extremely helpful. Food-inflation containment will also depend on a more focused rollout of rural infrastructure in terms of both transport and energy, mainly a public sector function.

A distinguishing feature of the golden era of growth (2003-08) was the dramatic doubling of private corporate savings from 3.9 percent of GDP during 1997-2003 to about 7.8 percent during 2008-12, reflecting the buoyant profitability of that period. High corporate investment levels were then enabled by the availability of both ample internal and external resources. The private corporate savings rate has since fallen by more than 2 percentage points. Higher nominal interest rates have adversely impacted corporate profitability and savings. Therefore, success with fiscal consolidation and inflation management, allowing a lowering of nominal interest rates, will have a positive impact on corporate savings and investment. Restoration of private corporate investment to its earlier level of 7.5 percent of GDP should then become possible within the next three to four years. We have then projected them to increase progressively to 9.5 percent by 2027-32.

This brings us to the desired trajectory of public sector savings, which consists of two broad categories: government per se and public sector enterprises. As a consequence of the fiscal stimulus of 2008-09, government savings turned distinctly negative, after having become mildly positive at 0.5 percent of GDP in 2007-08. This broadly corresponds to the revenue deficit of the center and states combined. Interestingly, public enterprises have maintained consistent positive saving rates of around 4 percent of GDP over the past decade and a half. With the envisaged fiscal correction for the next two to three years, government savings could again approach positive levels. Cutting subsidies, especially in energy, would free up around 1.5 percent of GDP. Accordingly, we have projected overall public sector savings to increase from the current level of just over 1 percent of GDP to 3 percent in 2017-22, rising to 3.4 percent by 2027-32. This is a relatively conservative assumption and so it is possible that even greater improvement can take place, particularly if the overall tax/GDP ratio can be improved over the years.

The fiscal stimulus of 2008-09 raised the fiscal deficit of the central government to 6.5 percent of

GDP, almost completely absorbing net household financial saving, effectively crowding out the private corporate sector. Thus, reduction in the overall fiscal deficit and borrowing requirements of the government is a *sine qua non* for the restoration of high sustainable growth. The second issue with respect to fiscal policy is to focus on the revenue side; the gross tax-to-GDP ratio of the central government has recorded a significant fall from its peak of 2007-08 of 12 percent, to 10 percent in 2013-14. Cross-country analysis indicates that the ratio of general government revenues to GDP in India is lower than Asian emerging market economies and, more generally, also lower than that in countries with similar levels of per capita incomes. Increases in the tax-to-GDP ratio can be achieved through greater buoyancy without any increase in tax rates, with a renewed focus on compliance. With the buoyant growth that the Indian economy achieved in the 2000s, and even since the NAFC, there has been a very substantial increase in middle and upper income households who should be taxed more. This is indicated, for example, by the increase in the number of cars sold from 1.5 million in 2007-08 to 2.7 million in 2012-13; and in the relatively booming housing sector.

India will also need to make prudent use of external savings to ensure external sustainability. Except for 2008-09 and 2009-10, which were crisis years for global trade, Indian exports of goods and services, in dollar terms, have been growing at 20-25 percent per year since 2002: Hence their share in GDP almost doubled between 1998-2002 and 2008-12. Accounting for the global trade slowdown and protracted slow growth in the advanced economies, we are projecting a relatively slower pace of growth at 11-12 percent between 2017 and 2032. Even at this pace, exports of goods and services would increase from the current level of about 25 percent of GDP to about 30 percent of GDP in 2017-22 and 38 percent in 2027-32, so this is a relatively ambitious scenario of export growth (the current level of exports of goods and services of China amounts to about 31-32 percent of its GDP). Imports of goods and services are projected to grow correspondingly.

With this scenario, the CAD is expected to be 2.5 percent of GDP, a level which is considered sustainable. Allowing 2 percent of GDP for foreign exchange reserves accumulation consistent with higher import levels so as to provide comfort to external lenders and investors implies that net capital flows will need to be in the region of about 4.5 percent of GDP during 2017-32. From an external sustainability point of view, and given the more volatile nature of debt flows, the projections assume that equity flows will dominate, at 60-65 percent of net capital flows, with debt flows (35-40 percent) being the residual. These proportions are also broadly consistent with the prevailing debt/equity ratios in the Indian corporate sector. The debt service projections in the current account are based on such a composition of capital flows.

Available evidence indicates that rapid financial sector and capital account liberalization often ends up in crisis; financial openness is not a panacea and it could instead be poison. Benefits of financial openness are most likely to be realized when implemented in a phased manner, when external balances and reserve positions are strong, and when complementing a range of domestic policies and reforms to enhance stability and growth.⁵ Thus, sound management of capital flows, particularly that of debt flows, is essential to preserve financial stability. On the positive side, one factor that reduces India's external vulnerability, despite large twin deficits, is the fact that public debt is mostly internally held. It would be prudent to continue with this approach and to keep external confidence in the Indian economy high so that relatively stable external capital flows are forthcoming.

Infrastructure Investment

Achieving a high sustained rate of economic growth requires corresponding investments in infrastructure, including all aspects of transportation. If manufacturing growth is to be ratcheted up to around 10 percent, and if there is to be the kind of trade growth projected, the demands for the provision of power, transportation and logistics will also grow commensurately. The continued

expansion of trade requires corresponding investments in ports, airports, and in all forms of domestic transport linkages.

With this perspective, infrastructure investment will need to pick up significantly in the coming years. NTDPC (2014) projects that overall infrastructure investment will need to increase substantially from around 5.4 percent of GDP in 2011-12 to around 8 percent during the 2020s and beyond—levels consistent with the economic growth and transformation experiences of Southeast and East Asian countries. While an increasing proportion of infrastructure investment could be undertaken by the private sector, the public sector will have to continue to play the predominant role in sectors such as electricity, railways, roads and bridges. The private sector can be the driving force in the “communications” sector, in ports and airports and in commercial vehicles. For the public sector to carry out the enhanced role, fiscal consolidation, as indicated earlier, assumes importance.

A key finding of the NTDPC (2014) is the clear need to substantially raise the share of Indian Railways in total infrastructure investment, from the current level of about 0.4 percent of GDP to 1 percent and above by 2017-22, and continuing at similar levels for at least the next decade and a half. This is essential for improving productivity of manufacturing overall, for linking inland nodes to ports to aid in the sustained growth required in trade, and for a sustainable environment. Total investments in transport (including railways), both public and private, would need to increase by around 1 percent of GDP above current levels.

Manufacturing

Globally, rapid industrialization and manufactured exports have been the most reliable levers for rapid and sustained growth. Virtually all countries that have enjoyed sustained high growth rates for decades have done so on the back of manufacturing, with the growth miracles of Japan, Korea and China being conspicuous illustrations.⁶ Thus, policies that promote manufacturing activity in India

will have a key role, although the cross-country evidence indicates that the structural change in favor of manufacturing has softened in many countries and some countries are exhibiting premature deindustrialization. This makes a sustained revival of manufacturing growth challenging. What is of the utmost importance is acceleration in manufacturing growth to levels approaching double digits and then sustaining it at such levels over the next twenty years and beyond.

With the Indian economy now being essentially open on the current account, future development of Indian manufacturing has to be internationally competitive. Although the Indian factor endowment is abundant in labor, Indian manufacturing has not been generally competitive in labor-using sectors: there needs to be a focused effort at correcting this, much as China and other East Asian countries have done over the past 30-40 years, by tackling legacy issues connected with regulatory impediments that constrain the use of both land and labor in Indian manufacturing. There has been a traditional prejudice against the location of industries in Indian cities, which is where skilled labor is likely to be available. Urban land ceiling regulations and other zoning requirements have limited the availability of urban land for industrial development. Whereas in successful manufacturing-oriented cities it is common to find multistoried structures housing clothing and other light industries, these segments of manufacturing are almost totally absent in Indian cities.

There has been longstanding discussion of labor legislation hindering investment in labor-using industries, along with small scale industry reservations. The latter impediment has now largely been removed, but labor legislation problems remain. The measures needed are well known, but reform has so far not been feasible politically. The way forward has to include quick and practical labor reforms accompanied by programmes such as unemployment insurance.

Persistently high inflation during 2009-13 has added to some exchange rate overvaluation during

this period, and this is clearly visible from CPI-based real effective exchange rate indices. Success with inflation management will provide a conducive environment for stability in the real exchange rate, which will encourage exports, manufacturing activity and corporate health.

It is this combined and focused approach to urban land and labor reforms, along with the maintenance of a competitive real exchange rate that can accelerate manufacturing growth in labor-using industries. In addition, it goes without saying that the efficient provision of power, transport, and logistics is also necessary.

India has also exhibited competitiveness in heavy industries such as steel, aluminum, and automobiles. Such industries are more affected by governance issues related to environmental and other approval processes that have become more cumbersome in recent years, and from inadequate infrastructure. Some of the approval process issues are already being addressed and perhaps need further focus.

Conclusions

India's growth record since independence suggests that it is capable of recording sustained growth over a long period, even if it is punctuated by some periods of lower growth because of business cycles or other reasons. Its institutional system has also demonstrated that significant policy changes are made in response to changing circumstances. Sometimes this is done relatively quickly, whereas at other times there may be significant delays before the needed policy change is done.

Much of the Indian growth record has been possible due to sustained growth in domestic savings and associated investments. The use of external savings has been important, but has been relatively limited as a proportion of total investment. Whenever growth has stalled, it has been associated with stagnation in savings and investment, usually in the presence of a deteriorating fiscal situation and higher inflation.

The immediate priority for returning the country to a sustained higher growth path is to achieve the kind of fiscal quality and low inflation level that was exhibited during 2003-08. Focused attention needs to be given to increasing efficiency and compliance in tax revenue collection so that the Indian overall tax-to-GDP ratio rises to levels consistent with comparable international experience. In contrast, the recent fiscal correction has generally been on reduction in expenditure and particularly capital expenditures. While it is necessary to curb ill-targeted subsidies, it must be understood that the restoration of growth involves increases in public investment.

If such macroeconomic stabilization, in terms of both fiscal deficit and inflation, can indeed be achieved over the next couple of years, the projections presented in this paper suggest that it is within the realms of feasibility that the Indian economy can return to a 8-9 percent growth path for a sustained period. This would then begin to replicate the kind of growth experience exhibited by East and Southeast Asian countries, including China, in the immediate past and Japan in earlier periods. However, we do need to note that the task ahead will be more difficult now in view of the protracted slowdown in global economic growth and in global trade. The silver lining is that the weight of the global economy is shifting to emerging market and developing economies. Thus, even if the North Atlantic economies of North America and Europe do suffer secular stagnation in growth, as some are predicting, it is possible that the impact on global growth and trade may be mitigated by counter balancing growth in EMDEs.

For the Indian growth story to exhibit that kind of dynamism, it is crucial for Indian economic policy to focus on the revival of double-digit manufacturing growth, as first envisaged in the Industrial Policy Reforms of 1991 and beyond. The achievement of such industrial growth needs the maintenance of appropriate interest rates, a realistic and competitive real exchange rate, and removing impediments in labor and land markets. In addition, Indian cities must become more hospitable towards the location of manufacturing activities.

Achieving high growth in India is quite feasible but also depends on a step-up in infrastructure investment in energy and transport, especially freight and passenger railways where the whole system needs reorganization. Given that the elasticity of power demand with respect to GDP is around unity, there will be a need for sustained and continued investment in power generation, transmission and distribution. Associated investment will be required for the timely supply of energy resources such as coal and petroleum in adequate quantity from both domestic production and imports.

With these measures in place, we believe that India can buck the trend towards growth slowdowns that are now appearing in other countries, advanced and developing.

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Endnotes

1. Derviş and Kharas (2014)
2. Kapur and Mohan (2014)
3. Mohan (2011)
4. The NTDPC was chaired by one of us, Rakesh Mohan, and the simulation projections were carried out under his supervision.
5. CGFS (2009); Obstfeld (2009)
6. Rodrik (2013)