Reflections on Recent Indian & Chinese Growth

India, unlike China, is hobbled by lack of political consensus on reforms and poor investor sentiment when it comes to stepping up investment, reducing consumption

ALOK SHEEL

SALAM

India was, till recently, the second-fastest growing major economy after China. Following the sustained slowdown in the global economy since the financial crisis of 2007, growth has fallen across the board, including in China and India (see accompanying table). It was expected that China would be more affected, given its dependence on export markets for growth. For the same reason, it was expected that India, a more domestically-driven economy, would be less affected — in 2009, goods and services exports comprised 40% of GDP in China, against 20% in India.

Although, in 2010, it may have seemed that this was indeed the case, in retrospect, the reverse seems to have happened, i.e, India has slowed more than China. As a result, Indonesia, which like India, is a more domestically-driven economy — goods and services exports at 24% of GDP in 2009 — has now replaced India as the second-fastest growing major economy. We need to understand why this is the case so that corrective steps can be taken.

While China experienced a huge external shock through the trading channel on account of the sharp decline in growth in its export markets in western countries, the impact on growth was not commensurate on account of its huge investment-oriented stimulus package. India too had a timely 'fiscal stimulus' — mostly by default than design — although not as large as that of China. While the final budgetary stimulus in 2008-09 was almost identical in both countries at about 3% of GDP, the actual Chinese stimulus through budgetary and banking channels may have been in the region of 4 trillion yuan, or about 14% of GDP. However, since private investment and consumption demand held up reasonably well in India, its recovery matched that of China.

The post-crisis global economy can be divided into two stages, separated by the 'Indian Summer' of 2010, the apparent strong recovery that soon yielded to frost and snow as global growth dipped sharply again in western economies in 2011, and further still in 2012. This has had a knockdown effect on both China and India. This time round, however, India has been more severely impacted. Declining confidence arising out of lower growth has also acted to drag it down even more sharply through hysteresis.

It is necessary to keep the following three factors in mind while trying to understand the sharper fall in Indian growth relative to China.

▶ First, productivity may have been seriously impaired during the crisis, that is reflected in a widening current account deficit, as Indian firms become less competitive. There are four reasons to believe why this is the case.

First, unlike China, the Indian stimulus was consumption rather than investment led. Second, whatever its social benefits, the National Rural Employment Guarantee Scheme may have had a negative impact on productivity through rising wages without a commensurate increase in output, and also shifted jobs from more productive areas to less productive, especially because of restrictions on capital expenditure in the programme.

Third, competitive gains deriving from a falling rupee have been countervailed by rising commodity prices. India's dependence on POL imports has long been its Achilles' heel that, inter alia, was the trigger of the BoP crisis of 1991. Fourth, sustained high inflation relative to other emerging markets may have led to loss in competitiveness. This inflation is mostly commodity-led, and largely explained by the need to raise administered POL prices and the structural rigidities in agriculture as a result of which the supply response to rising prices is weak. The consequential supply shock has created a stagflationary environment of low growth and high inflation.

▶ Second, India had less fiscal space than China to begin with, and it exhausted this space during the first phase of the global financial crisis itself. It now finds that it has little fiscal space to counteract the decline in private demand. Contrariwise, China has enough fiscal ammunition left, which it is starting to use. The long-term sustainability of an investment-driven growth strategy in an environment of a permanent fall in external demand is, of course, moot in the absence of internal demand rebalancing.

▶ Third, the debate over Indian monetary policy is a red herring, as real interest rates are negative if the CPI measure is considered. Indeed, negative real interest rates may be adversely impacting bank deposits and financial savings without stimulating investment. Inflation acts like a tax by eroding real incomes and, hence, consumer demand. The bottom-line is that as a tool to stimulate private demand, monetary policy is as emasculated in an inflationary environment as it is in the kind of liquidity trap prevailing in advanced economies.

India is now trying to change the fiscal policy mix by reducing consumption and increasing public investment, and also trying to build consensus on accelerating structural reforms to stimulate private investment. However, there is little fiscal space for aggressive use of fiscal policy, and the political climate for major reforms remains uncertain and volatile. Also, no major steps are contemplated to correct restrictive agricultural policies and market rigidities so as to raise price responsiveness and the flow of capital into the sector to raise productivity. Incidentally, this is the only sector of the Indian economy unaffected by the major reform, liberalisation and opening up since early 1990s, and may be becoming the second Achilles' heel of the Indian economy.

(The author is a civil servant. Views are personal)

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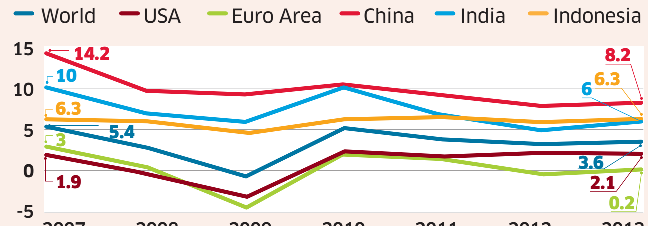
Real GDP Growth: Percentage Change Per Annum



SOURCE: IMF, World Economic Outlook, October 2012

Letter From London | Sudeshna Sen

Davids of the World, Unite!

It's a fact universally acknowledged by all powers that be, in every country, that the lifeblood of a country's economy are its small and medium companies, innovators, entrepreneurs, start-ups and small shopkeepers. The butcher, the baker, the candlestick maker. It is to allegedly protect the interests of these people that the BJP consistently refuses to let Parliament work, that innumerable management gurus write erudite tomes, and various government dignitaries in the UK and Europe frequently announce complex funding and education schemes that sound very good — but mean pretty much nothing.

Never have I heard so much noise about SMEs as in the last few years in the UK; not surprising, given that it's a country dominated by companies often as small as teams of less than 10 employees. We're being told that it's the little guys who are going to save us all from the dead-end recession we're in, thanks to the mess created by big banks on one hand and big government on the other. People are extremely fond of quoting some random statistics about how if every SME in the country hired just one more person, unemployment would be dead for the next century or whatever. It's serious hug-an-SME season.

If you talk to anyone in the SME sector though, whether it's in innovation, manufacturing or services, they'll tell you exactly how high the cards are stacked against them, either in Europe or India. A recent survey found that only 7% of UK SMEs think they can compete with bigger players in bad times. Take a couple of recent examples. Over the weekend, the EU (as usual, sigh) failed to come to any consensus on its own budget for the next seven years. Never mind the political schisms, I was taking a look at the proposals put up by the commission. The fat cat EC bureaucrats didn't get a pay cut. French and Italian farmers actually got a raise on their agricultural subsidies. Guess who got shafted? Funding for small business and a cross-EU infrastructure project.

Take another example. There's a lot of activism going on — all around the world it seems — about these big multinationals that don't pay taxes. Starbucks, Amazon, Google, Thames Water, now even Cadbury in India, not to mention Vodafone — the list seems almost endless. Everyone — both governments and taxpayers — has suddenly become outraged that these megaliths pay peanuts compared to you or me. Oh, c'mon folks. International taxation policies have been intensely complex for years, in a way that automatically gives big MNCs an unfair and inherent advantage. Joe Blogg's corner coffee shop cannot set up his holding company in Cayman (or Mauritius), which can buy cheap and ethical coffee beans from his subsidiary in Kenya, and sell expensive coffee in Mumbai or Paris, but show no profits because those subsidiaries bought the beans dear from the holding company. (That, simplistically, is what they call transfer pricing).

Joe Blogg can't even move his own residency to Monaco, or afford the team of highly-expensive lawyers and accountants who can manoeuvre through the maze. So he's already paying far more than his big neighbour on tax. Ditto for finance, which he can't source as cheaply, because banks won't lend to them, never mind a dozen grand funding schemes announced by UK authorities. To make things even worse, he's constantly being exhorted to seek new markets overseas, like in India, else he's going to have to shut his shop. Right.

A couple of weeks ago, I was moderating a panel for CII on the opportunities for British businesses in India's infrastructure industry. It's one of those recurring themes on the Indo-UK circuit: India needs one trillion in infrastructure development, we needs millions of kilometres of roads, bridges, towns, airports, ports and what have you. We're hoping to rebuild (I think that's what Kamal Nath said) some 70 new metro cities, build metro lines in another half a dozen. All very impressive.

But what the audience of infrastructure providers in UK really wanted to know was how, if I'm, say, an urban lighting or sewage treatment firm in Basildon, or a small legal firm or boutique financial firm in London, or someone who makes specialist doors or components for earthmoving equipment, can I get a slice of the action?

It's all very well for Indian experts to tell in London that, yes, we've got room and opportunities, and crying needs for all kinds of providers, but small firms don't even know how or where to begin. It's too big, too complex, and far too scary. None have either the resources or people to navigate the ever-shifting sands of Indian infrastructure projects.

International taxation policies have been complex in a way that automatically gives MNCs an unfair and inherent advantage

And that's the tragedy about Indian policy at the moment. The benefits — or not — of what happens to Ikea or Wal-Mart will only show results a decade later. Right now, what the country needs is more trade, and investments in projects already on the ground. It took over 100 companies — big, small, medium, public, private, consortiums of all shapes and sizes — to put together the London Olympics.

If the Indian government is serious about infrastructure development, it's going to have to look beyond a few big-name consortiums, and make it accessible to a larger and more diverse range of overseas players. If rules for Ikeas and Wal-Marts are bristling with exceptions to protect Indian SMEs — the efficacy of that is another story — why expect small guys in Basildon to compete at the same level as a JCB? Every government in the world wants the private sector to generate flagging global economic growth. If SMEs are the backbone of any private sector, just going around hugging them isn't enough — like all minorities, it's time for serious affirmative action at an international level.

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Perspectives

To Auction or Not: Is That the Question?

Policies to allocate natural resources should be dynamic and innovative, and the process wholly transparent

PRADEEP S MEHTA

The Supreme Court is rightly peeved that the government did not auction the entire spectrum vacated as a consequence of the cancellation of the dirty licences in February, and so are the people of India. But even if the government had done so, the heroic recommendations on a high reserve price might have had the same result. The 122 licences allocated on a distorted first-come-first-served (FCFS) policy in 2008 was a case of undervaluation with mischievous intentions, while now the pendulum has swung to overvaluation, ignoring sluggish consumer demand. An FCFS policy on its own can be a good way, so as to avoid overvaluation, but then, it has to be done transparently and equitably.

Today, we are no better off in seeking an acceptable solution to the growing malaise in allocation of natural resources that is not limited to airwaves. After the furore following the arrest of former telecom minister and the Supreme Court's February 2012 verdict cancelling all the 122 telecom licences, the Telecom Regulatory Authority of India (Trai) was asked to make fresh recommendations for grant of licences. Later, in September 2012, in response to a Presidential reference, the SC clarified that the Constitution does not mandate an auction-only policy in allocation of natural resources. It added that the 2G case order of an auction-alone policy cannot be applied to other natural resources, and that revenue maximisation is not the object of the policy of allocation of natural resources. The apex court also emphasised that it respects the mandate and wisdom of the executive in such matters, but all such allocations have to be guided by common good and that courts will not hesitate in striking down any arbitrary allocation.

Lacklustre response to the recent 2G auction calls for capacity building within the government to organise, design and implement auctions

The process of evolution of a policy has taken too long to crystallise. Surely, there are lessons to be learnt. In the wake of disclosures highlighting crony capitalism aided by the prevailing opaque processes, dubious pricing, suboptimal utilisation of such resources and corrupt practices, the Ashok Chawla Committee on Allocation of Natural Resources submitted its report back in May 2011.

The objective was to help the government allocate natural resources in a more transparent, efficient and sustainable manner. However, the report has not been made public though its contents have been widely discussed across ministries, businesses, experts, economists, etc. This seminal work should not only be placed in the public domain for a more informed debate, but the government must also proactively inform of its status of acceptance and implementation. The panel's recommendations reiterate merits of transparency, public disclosure, consultation, capacity building, competitive bidding and expeditious clearances. As can be seen, some of these factors resonate in the recent decisions of the Supreme Court on the issue and worthy of being incorporated in relevant policies.

It is absolutely essential to first review and revise policies on a regular basis and to build therein the changing market scenarios. In telecom, for instance, the regulator could look at a hybrid bidding parameter with a one-time payment and a periodic payment of usage linked with earnings and spectrum-usage charges. Such an innovative approach would have also neutralised the 'winner's curse' potential that may apply to the two new successful bidders, Telenor and Videocon.

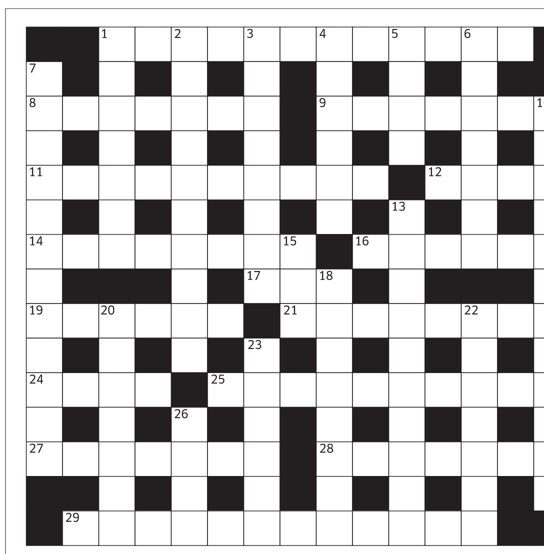
In the case of new oil block auctions, review of policy has already been initiated for the better. The government plans to initiate the 10th round of auction under the new exploration licensing policy (Nelp). Production-sharing contracts to attract more domestic and foreign investors will be the lodestar. Such an approach needs to be taken by all ministries responsible for allocation of natural resource concerned, and on a dynamic basis.

The recent lacklustre response to the 2G auction indicates the necessity of capacity building within the government to organise, design and implement auctions. Frankly, retired bureaucrats are not the best resource pool for economic regulators, but that is another story. Spectrum allocation and pricing are complex issues, given the nature of the telecom industry in India, and it needs far better capability than what exists. The design of the auction was such that it had been widely predicted in the media to fail. Unless the intention was for the auction to fail, to justify the 2008 policy of FCFS and to discredit findings of the CAG, trained and skilled personnel might not have made such heuristic recommendations of a high reserve price merely on the basis of the 3G auction. Determination of the market conditions may have revealed sluggish consumer demand. That would have necessitated recalibration of the reserve price and making it more relevant.

As we reform our resource allocation systems, it may be worthwhile to look at the experiences of other resource-rich countries. A recent study by Lisa Sachs, Jacky Mandelbaum and Perrine Toledano that surveyed 29 predominantly mineral-rich developing countries found existence of the sensible process of competitive bidding in over half of the countries. On the other hand, Chile has a strict FCFS system that is highly regulated and legally enshrined that constrains discretion of officials along with reducing opportunities for allocations based on cronyism and bribes. Our own reforms, while learning from such examples, have to be India-specific.

(The author is secretary general of CUTS International)

The Crossword 5421



ACROSS

1 Difficult to know how deep the sea is (4,2,6)
8 One's not out to enjoy some advantage (7)
9 Female employees on reduced diet (7)
11 Curb a lion's unusual help to take the long view (10)
12 For a traveller it's advisable to hold it (4)
14 No boss seen to have nothing at the top (8)
16 Make another mess of what's already written (6)
17 Be sorry for top man not quite making a comeback (3)
19 Take right turn in having to compete with good quality (6)
21 One may have to take down what's said by an autocrat (8)
24 Get rid of some notorious traitors (4)
25 One might come between Christian and family (6,4)
27 Complaining at not being able to begin following (7)
28 Declare a boy has to be turned away (7)
29 Bored by having no return on your investment? (12)

DOWN

1 Praise God for starting happiness with big girl! (7)
2 Making no sense of what's obviously not sublime (10)
3 Let's rise and get around without having to stop (8)
4 Top cover provided by Iron Lady (6)
5 Rubbish may be shot here (4)
6 Ring for transport to take in a music-maker (7)
7 Let him be various in ways of doing wrong (12)
10 Down on top people who are frivolous (7-5)
13 The colony that's been arranged (10)
15 One's in the ground therefore dead (3)
18 Flight freedom is restricted here (8)
20 Foreigner in a hurry, one might almost say (7)
22 Warmed by a wish for health (7)
23 One on the beach not getting hot (6)
26 Give a nominal indication (4)

Solution to 5420

ACROSS: 1 Masseur. 5 Cactus. 9 Nervous. 10 Example. 11 Can. 12 Hand in glove. 13 Brand. 14 Behaviour. 16 Boulevard. 17 Liner. 19 Copperplate. 22 End. 23 Leisure. 24 Visible. 26 Mettle. 27 Letters.

DOWN: 1 Mini-cab. 2 Spring a surprise. 3 Ego. 4 Risen. 5 Cherished. 6 Clang. 7 Unpronounceable. 8 Meteor. 12 Hedge. 14 Blaspheme. 15 Value. 16 Buckle. 18 Redress. 20 Erupt. 21 Anvil. 25 Sot.

The Daily Mail

Dilbert by S Adams