

theirview

India in the global economy

Since the revival of external demand is uncertain, India's primary focus should be on leveraging domestic demand

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is a civil servant. These are his personal views.

Global growth has been tepid since the global financial crisis broke out almost 10 years ago, having declined from an average of 4.5% during the five years preceding the crisis to 3.5% over the past five years. Both advanced economies and emerging markets have suffered. Growing significantly faster than global gross domestic product (GDP) in the pre-crisis period on the back of global production chains, the extent of decline in global trade is particularly surprising, considering that the G-20 moved nimbly to forestall a cascading Smoot-Hawley type protectionist response that occurred during the Great Depression of the 1930s.

Indian growth and exports have also shrunk. Central Statistics Organisation and International Monetary Fund numbers indicate that India is now the fastest growing major economy in the world. The divergence between macro growth estimates and other indicators such as Index of Industrial Production, exports, corporate profits, credit growth, investment data has, however, fuelled speculation that India's growth may have suffered as much as China.

China's growth has been badly hit because of its reliance on external demand. The sharp decline in Indian growth is surprising, as India's primary engine of growth is putatively domestic. A closer analysis reveals that India was indeed less dependent on global demand than China at the beginning of the global financial crisis, exporting just 20% of its goods and services, compared with China's 40%, in 2007. By 2012, however, India's ratio had risen to 24%, while China's had declined to 27%. India's adjustment to the global demand compression was thus more imbalanced than that of China. Indeed, part of the decline in China's growth reflects a deliberate attempt to change its risky growth model by rebalancing its economy away from external demand and investment

towards consumption.

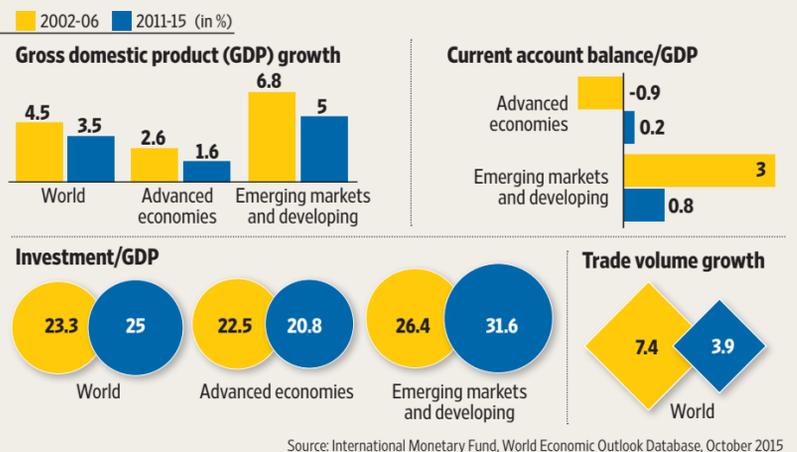
What should be India's strategy for realizing its undoubtedly high growth potential in the current scenario?

The global economy has so far relied on demand in advanced economies as its engine of growth. This model of global growth is being undermined by adverse demographics and declining returns to labour on account of globalizing forces resulting in stagnant real wages. These forces were suppressed by an unsustainable increase in leverage in the pre-crisis period. Leveraged consumption growth in advanced economies via an asset boom enabled developing economies to register very high rates of growth through global imbalances. Their cumulative current account surplus moved from deficit to an average surplus of 3%.

Adverse demographics and stagnant real wages, alongside the overhang of private debt and tightening of financial regulation in the post-crisis period, has led to deleveraging and demand compression in advanced economies. Unconventional monetary policy has been unable to revive demand, with liquidity injections washing back as banking reserves on the central bank balance sheet in what is described as a liquidity trap. Governments have levered up to unprecedented levels to compensate, but fiscal multipliers have been surprisingly weak for reasons that are hotly debated, ranging from Ricardian equivalence to the stimulus not being aggressive enough.

The revival of consumer demand through the widely hoped global rebalancing has not occurred: developed countries have lowered, and developed countries have increased, investment as a share of GDP, instead of the other way round. There is now a consensus, forged within the G-20, that the revival of animal spirits and return to a high growth trajectory need far-reaching structural reforms, in both advanced and developing

GLOBAL MACROECONOMIC PARAMETERS



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countries. These are politically challenging in democracies, more so when little fiscal space is available to cushion their impact.

With the global economy in search of a new engine of growth, and with India emerging as the fastest growing major economy, there is some speculation that India might take over China's role. The entry of China into the World Trade Organization (WTO) at the turn of the current century was a major stimulus for the global economy, with growth rates rising in both emerging markets, with whom China ran large deficits, and in advanced economies, with whom it ran large surpluses. China's share in the global economy at the time was less than what India's is today. According to the IMF World Economic Outlook database October 2015, China's share of the global economy measured in current dollars was just 3.4% at market exchange rates, and 4.5% at purchasing power parity (PPP) in 1999. In comparison, India's present (2015) share at market exchange rates is 4.8%, and 7.1% at PPP.

China leveraged its entry into the WTO to become the global manufacturing hub, catering to robust consumer demand growth in advanced economies. Its own final consumer

demand was too modest to serve as the engine of growth for the global economy. The problem in replicating the Chinese model is twofold. First, external demand is weak and global trade is in reverse gear. Second, the environment for manufacturing in India is not very competitive, with its known constraints in infrastructure, tax administration, legislative logjam, and land and labour markets.

Three things are abundantly clear. First, on current form, India is unlikely to be the new engine of growth that can revive animal spirits and drive the global economy out of the Great Recession. Second, it needs to improve its export competitiveness through politically challenging structural reforms, rather than follow the western folly of expecting monetary policy to do so. Third, since the timeline for the revival of external demand is uncertain, the primary focus of its Make in India, Start-up India and Skill India initiatives should be on leveraging domestic demand. Even so, in an open economy, the success of a domestically driven Make in India initiative hinges on becoming globally competitive.

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