

# theirview

## Coping with global headwinds

**India and China withstood the financial crisis of 2008. India needs to do more to be prepared for any crisis**

**Alok Sheel**  
is a civil servant. These are his personal views.

The global financial crisis, and recent projections by the International Monetary Fund (IMF) for Chinese and Indian growth, raise some interesting questions regarding key drivers of economic growth in India and China.

When the global financial crisis swept across the world in 2008, it was widely hoped that India would not be as badly affected by the external demand shock as China. After all, the export of goods and services accounted for about 40% of Chinese gross domestic product (GDP), and domestic consumption for around 50%, while India consumed over two-thirds of its GDP and exported only around 20%. Moreover, a decade earlier, the East Asian crisis seemed to have bypassed India.

As things turned out, while both economies initially had a relatively soft landing, Indian growth has dipped more sharply than that of China if we go by the old, less controversial, national income data generated by the Central Statistical Office.

Why? The popular notion is that Indian growth fell off because domestic demand resilience levelled out, and the productivity of capital declined on account of mounting infrastructural and governance bottlenecks. However, India's initial soft landing relied more on external demand than is commonly believed. As export growth floundered on account of a "second dip" in the global economy following the sharp recovery of 2010, its growth fell off sharply.

External drivers had left a strong imprint on Indian growth prior to the East Asian crisis. The sharp increase in India's trend growth after 1991 went hand in hand with greater outward orientation. Indeed, the trigger for this opening up was itself externally driven: a sharp rise in international oil prices and a sudden stop in capital inflows in the wake of the Gulf War of 1991. The real surprise is why

the East Asian crisis did not affect India more than it did.

Going forward, IMF's projections indicate that, despite global headwinds, India's trend growth will overtake China's. Such projections necessarily assume, inter alia, that external headwinds will impact China more as it is more dependent on global demand than India.

Is this a reasonable assumption? To answer this question, we need a better appreciation of the dynamics of Indian growth over the last quarter century and the role of external factors in strengthening as well as moderating growth. These dynamics have critical policy implications, such as for the "Make in India" campaign. Should this focus more on external markets, or on domestic?

Goods and services exports comprised less than 7% of the national income in 1990. The sharp increase in the external orientation of the Indian economy thereafter was facilitated by the growth of both manufacturing and services exports, led by information technology-enabled services (ITeS). Merchandise exports' share in GDP doubled, and services' share almost trebled after 1990.

This external orientation coincided with a sharp increase in trend growth. But India was much less dependent on global demand than what China was at the outset of the global financial crisis, exporting just 20% of its goods and services, compared with China's 40% in 2007.

By 2012, India's ratio had risen to 24%, while China's had declined to 27%. India's adjustment to the global demand compression in the wake of the global financial crisis was thus more imbalanced than that of China.

Although Organisation for Economic Cooperation and Development (OECD) countries still account for the lion's share of aggregate final global demand, the last few decades witnessed a rebalancing of global demand. Trend growth declined in



OECD countries even as it accelerated in emerging markets and developing countries.

The direction of Indian merchandise trade has adjusted to this demand rebalancing by moving away from OECD and Commonwealth of Independent States countries to China, Association of Southeast Asian Nations and the Middle East. India's booming service sector exports, which grew robustly on the back of high per capita incomes in OECD countries, have however not rebounded. These have been badly affected by the demand compression in OECD countries in the wake of the global financial crisis. The share of service exports in the national income stagnated at around 8% between 2007 and 2012, even as that of manufacturing rose from 13% to almost 17%.

The sharp slowdown in growth in both China and India despite the initial soft landing suggests that while their strategies for cushioning the impact of the global slowdown yielded short-term results, the strategies are unsustainable if demand compression in advanced economies is permanent, which might well be

the case. Both economies need rebalancing. China needs to consume more and invest less to reduce its reliance on foreign demand, which is what it is consciously seeking to do. India's ITeS sector needs to develop more domestic demand linkages and diversify its external demand away from its narrow US-Western Europe focus, just as its merchandise exports have done over the years.

The Indian economy, which began the crisis fairly evenly balanced between consumption, investment and foreign demand, also needs to invest more, especially in infrastructure, and improve the ease of doing business. Experience indicates that ramping up consumption to revive growth without boosting productivity is likely to lead to economic imbalances in the form of inflationary and current account pressures that ultimately derail growth. A more sustainable strategy to boost growth lies in improving the efficiency of capital deployed, and in "switching" public expenditure away from consumption to infrastructure investment.

Comments are welcome at [theirview@livemint.com](mailto:theirview@livemint.com)

# otherviews



## The tech productivity mystery

**Noah Smith**  
is an assistant professor of finance at Stony Brook University.

One of the key debates about economics is whether new technology is making us more productive. This is very important, since productivity has been the key to the vast increases in human living standards in developed countries during the past two centuries. Now the numbers are slowing again, and economists are worried. How does the tech industry fit into all this as the economy returns to something resembling normality? In terms of productivity, is tech our salvation, or a false hope?

On one side of the debate, we have John Fernald of the Federal Reserve Bank of San Francisco, an expert on measuring technological productivity. On the other side, we have the economics research team of Goldman Sachs, one of the most respected in the private sector. The quality of our future could hinge on which one of these heavyweights is right.

Traditionally, when economists wanted to figure out how productive technology makes our economy, they just netted out the contributions of "factors of

production" such as labour and capital, and whatever is left over—called total factor productivity—was regarded as technology's contribution. Fernald realized that this was an oversimplification, since it didn't take into account other factors—like how intensively capital was used. He "purified" the measurement of technological productivity and came up with numbers that were very different from what economists were using.

In 2014, Fernald wrote a paper titled *Productivity and Potential Output Before, During, and After the Great Recession*. The paper confirms that, since about 2003, measured productivity growth had slowed down. But he also looked at industries that either produce information and communication technologies, or use these technologies intensively—in other words, IT industries.

He found that IT industries contributed a lot to the productivity boom in the late 1990s and early 2000s. But then IT-related productivity slowed dramatically.

Fernald's data is very worrying—if he's

right, it suggests that the IT boom was a short hiccup in a long-term slowdown.

But economists Jan Hatzius and Kris Dawsey of Goldman Sachs are sceptical of Fernald's findings. They note that the stock prices of tech firms are high, meaning that investors expect big things in the sector. Profit margins—not a measure of productivity but an indicator of companies' overall health—have also risen.

What could be going on? Is the market overvaluing tech companies, or are they more productive than Fernald's numbers suggest? Hatzius and Dawsey suspect national economic statistics in the US themselves are to blame. They note that it's very difficult to measure the quality of IT products. If quality increases while prices and sales stay the same, productivity has gone up, but official statistics won't record the increase. There is also the problem that innovation in IT regularly produces new kinds of products, which people use to replace old kinds of products. When this happens, the overall cost of living goes down—for example, if

people read free social media instead of watching TV for their entertainment. But economists measure inflation by measuring changes in prices for the same goods, so they will miss this kind of change, and end up overstating inflation—which understates productivity.

A burst of innovation could therefore be causing official IT productivity growth numbers to plummet, even as it increases true productivity by improving quality and introducing new goods. If the official statistics are biased, then even the meticulous, brilliant Fernald won't be able to get meaningful results from the data.

So this is the debate. If you believe that the official price statistics give an accurate measure of the cost of IT, then you should be worried about a slowdown in the sectors. But if you think that the unique nature of IT makes price statistics unreliable, then you shouldn't worry.

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