

End of the India story?

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Over the last year or so, several articles, research reports and a few books have been published, all of which essentially reach the same conclusion. The India growth story is real and here to stay.

The acceleration in growth since 2003 reflected a structural shift in the economy's trajectory, which was triggered by the cumulative reform process having reached a critical mass. India may have to play second fiddle to China as far as growth is concerned, but it was an uncontested second and more and more people began to speak of China and India in the same breath.

Of course, we know that all stories must eventually come to an end, even good ones, but the consensus was that this one had a pretty long way to go.

Unfortunately, just as the conviction about India's rosy future was beginning to entrench itself, things look like they are unravelling. The horrors of the past few weeks are vivid. Surging inflation, unprecedented oil prices, the fiscal situation threatening to slip out of control, foreign investment flows reversing and inducing the rupee to depreciate - the list of economic woes just keeps expanding.

Granted that external factors are a significant reason for this situation, but the fact that the Indian economy has, in a matter of a few months, gone from being the pick of the emerging markets to looking tired and vulnerable does raise a fundamental question.

Was the impressive performance of the past few years the beginning of a sustained run or merely a final burst before caving in to all the internal constraints and contradictions?

The answer to this question depends critically on how one interprets recent macroeconomic developments and the policy responses to them. At one level, it is reasonable to see the emerging growth-inflation-fiscal-balance of payments configuration as the unfolding of a typical business cycle, though aggravated by adverse supply conditions, from oil, food and other commodities.

The management of a conventional business cycle using monetary and fiscal policy instruments is certainly within the capacity of emerging economies with relatively well-developed financial systems.

The complexity added by the supply-side factors makes the process much more difficult, but not intractable. However, in these testing times, India, along with many other emerging markets, is making heavy weather of it.

The only tenable response to a supply shock is to let domestic consumers face the new price scenario and deal with it. The quicker the adjustments, in terms of conservation and substitution, the less time it will take for the economy to return to a sustainable macroeconomic trajectory.

The adjustments will inevitably be painful, so the policy approach should certainly find ways to mitigate the pain but it simply should not deter or postpone the actions required. As far as oil prices are concerned, the Indian government has finally made a beginning, however small, in initiating the adjustment.

Several other countries that had similarly resisted the change have done so, which should ultimately contribute to a reduction in global consumption and, in turn, to lower prices. That may take a while but at least the process is in motion.

However, the India story was never about business cycles or efficient macroeconomic management. It was about strong domestic drivers of growth, of skilled workers and ambitious entrepreneurs, all striving for success, in a facilitating environment that progressive policies helped create.

The sheer numbers of workers and entrepreneurs, all of them consumers, provided strong assurance that the process would remain invulnerable to global turbulence. If we were to interpret recent developments against this backdrop, there are clear reasons for concern.

The key words here are "facilitating environment". Several years of fiscal discipline have given way to potentially runaway deficits as oil and fertiliser subsidies grow out of control.

The capacity to resist supply shocks with higher subsidies is always limited and works only when the shock is temporary. If persisted with, an increasing subsidy bill crowds out many other uses of public funds. Investment in infrastructure and spending on social welfare are the obvious victims.

One could argue that the reduction in resource commitments to these critical activities can be offset by increased efficiency. That is clearly an opportunity, but requires fundamental changes in organisation and incentives, of which there is simply no evidence.

Apart from the supply shocks that were referred to earlier, the economy is facing some serious ones that are entirely of our own making. The shortage of skilled labour threatens the competitiveness of many sectors that contributed heavily to the growth surge in recent years.

And, as the growth rate accelerated, it aggravated shortages in physical infrastructure, which, apart from a few exceptions, seems hamstrung by the sluggishness of both policy reforms and implementation.

The food price scenario is another threat to the durability of the growth story. Years of declining public investment in the rural areas, combined with input and product price distortions, have contributed to volatility in production and prices, leaving households vulnerable, despite higher incomes.

Developments that would make the farm to consumer linkage more efficient, benefiting both in the process, like the facilitation of organised retail, have been resisted. Mispricing inputs like fertilisers and fuel deters conservation and aggravates the fiscal situation, while not really providing a solution to the problem of volatility.

One could go on, but the essential point is that many of the symptoms of the current economic condition do appear to have a long-term dimension which poses risks for sustainable rapid growth.

The common feature of these is that they are the consequence of government actions: either the failure to take appropriate ones or the enthusiasm to take inappropriate ones.

A closer look at all the rosy prognostications about India's economic future reveals that they are largely conditional ones. The future is contingent on economic reforms continuing to provide the same kind of facilitation to businesses, workers and consumers that they did since 1991.

If reforms were to end, after some lag, so would the Indian story. Yes, the current situation is the result of several short-term and external elements. But, the response of the economy to these threats reveals an underlying vulnerability, which is the consequence of so many constraints having been inadequately addressed by the reforms agenda.

Someone once said about the Chinese economy that it was "condemned to grow". The twists and turns of India's growth story suggest that it is "condemned to reform".

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