Logo

Subir Gokarn: Re-visiting growth drivers

Past growth acceleration provides lessons for policy responses to current situation

Subir Gokarn | New Delhi February 23, 2009 Last Updated at 00:38 IST

The growth acceleration earlier in this decade provides lessons for policy responses to the current situation, says *Subir Gokarn*

As we struggle with the challenge of taking the Indian economy back to a growth rate of 9 per cent, it is important to remember that this is not the first occasion in recent years on which we have faced it. From 1997 to 2002, the economy appeared to have fallen into a stupor, with growth rates barely crossing the 5 per cent mark. By sharp contrast, from 2003 to 2008, growth averaged over 8.5 per cent per year. Understanding the factors that caused this very significant acceleration is critical to designing policies that will not just induce a recovery but also sustain relatively high growth in the coming years.

Economic success is invariably the result of good policy made in a favourable environment. We now know that the global economy was passing through a purple patch during the period of our own high growth. This clearly contributed to our performance but, just as clearly, was not the only reason for it. A series of policy initiatives taken since 1999 had a very significant impact on growth.

The first of these was the tax concessions given on housing loans — interest payments on loans were made deductible from taxable income. The second was the progressive deregulation of interest rates. Most importantly, even though it was not formally deregulated, the interest rate on small savings was brought down in phases from 12 per cent to 8 per cent. The third was the launch of the highway development programme.

The combination of the first two measures provided a huge stimulus to the then nascent housing sector. The effective cost of borrowing went down dramatically, inducing a very large number of relatively recent entrants into the white-collar workforce to buy homes. Lower interest rates also led to the huge expansion of retail finance, which provided a boost to automobiles and consumer durables. The combined multiplier effect of this helped to ratchet up the growth rate of the manufacturing sector.

Third, government support for the highway programme, either through direct spending or financial guarantees for private developers, not only helped to boost demand for construction materials and services, it resulted in a very large number of jobs being generated across the country. While construction jobs may be temporary, the emergence of a highway tends to create several opportunities for more sustained employment growth.

Of course, these initiatives may not have worked if several other factors had not been present. The best way to interpret the high growth phase of 2003-08 is to see these three measures as catalysts that brought together a range of factors to generate significantly greater momentum than had existed before. This momentum, in combination with positive global conditions, took the growth rate to the unprecedented levels that we saw during this period.

Three attributes of this combined set of drivers need to be emphasized as we consider our options today. First, there was an important element of “reform”, particularly in the case of the interest rate measures. We did then and we must continue to view the reform process as a means to expand the space in which entrepreneurial initiative can operate. That compulsion has not changed, even as we recognize that the space cannot be expanded indefinitely or without some checks and balances.

Second, even with the reformist element, the government played a strong role, both directly — the highways programme, and indirectly — the tax concessions. Analysis of episodes of sustained growth over time and across countries overwhelmingly supports the view that the state will play a role in it. We have begun to find ways in which the role of the state can be constructive and facilitative rather than being a hindrance.

Third, the role of the government did not come with a compromise on fiscal discipline. A combination of dedicated funding — the road cess on fuels — and structural improvements in the tax system helped create enough fiscal room to bring deficits down, both at the centre and the states, even with the tax concessions and the higher expenditure commitments.

Finally, to complete the picture, the contribution of favourable global conditions also needs to be recognized. Rapid growth in exports, both of goods and services was, of course, one manifestation. The other critical one was the huge increase in capital inflows, which, notwithstanding the problems they created for macroeconomic management, contributed to a significant rise in investment levels, which themselves were motivated by the improving domestic environment.

The question is: can we replicate this virtuous combination? Let's begin with the easiest component first. We cannot, under any reasonable circumstances, expect global forces to play the same role in the coming years that they did during 2003-08. In particular, expectations of large inflows that will fund the ambitious infrastructure targets of the Eleventh Plan are now completely unrealistic. We will have to find substitutes, either domestic or through alternative foreign channels. This should be a priority objective for the recovery plan. However, realistically, less favourable global conditions will have an impact on our growth rate, something which we must factor into all our projections.

Can the domestic drivers reprise their role? If we look at "reforms" more generally as a driver of growth, there are certainly opportunities for replication. There obviously isn't much room left to change the structure of interest rates, but this does not mean that a variety of other reform measures cannot have essentially the same impact. Labour market regulation would be my priority. Combined with the expansion of the rural employment guarantee to provide a safety net for the urban blue-collar workforce, reforms in this area can provide a boost to manufacturing comparable to interest rate deregulation, while simultaneously mitigating the burden of income uncertainty on households.

Similarly, cleverly financed public spending programmes still have enormous room to make a contribution to growth. The highway and supporting road network is far from complete and should be an immediate priority as a way to re-create large numbers of jobs. But, we could look beyond roads to, for example, a country-wide programme for re-constructing existing schools and building new ones.

The bottom line is that we have in the past achieved strong growth momentum with an intelligent mix of policies. Essentially, the circumstances are not very different now. The individual policy initiatives may not be replicable but the forces they generated can certainly be re-generated by a series of other measures.

The author is Chief Economist, Standard & Poor's Asia-Pacific. Views are personal