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India, Be the Outlier

As the stars of developed economies ascend and of BRICS descend, here's how India can buck the trend

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The world economy is changing rapidly. The stars of yesteryear, the BRICS, are down and the stars of the world's leading economies are ascending.

A simple comparison of GDP growth forecasts for the US, BRICS and India will underscore this point. In 2006-07 India came within a whisker of double-digit growth and the US was growing at 3%. In 2014, US is expected to grow at 3% while India would not dare to predict a rate anywhere over 5-5.5%. In short the growth differential has compressed by a hefty 4 percentage points.

The recovery in the developed world might be led by the US, but others such as Europe and Japan are showing signs of life. So money in the foreseeable future is likely to move to developed economies. The dollar will strengthen, dollar interest rates will rise and, as a mirror image, emerging economy stocks and currency will fall and commodity prices should stabilise or rise.

Mercifully, the developed world needs emerging markets to grow, which in turn requires capital, and so some money must come back. But which emerging markets will manage to attract more capital depends on how quickly they get their economic act together.

The pundits are making all sorts of forecasts. Some of them still work on the assumption that convergence of the rich and the poor world is almost axiomatically inevitable. However, convergence based on differential growth rates sustaining for the long run can work only if poorer countries work hard to remove supply shortages, improve human capital and physical capital and not mistake episodes of easy money and asset bubbles as a sign of affluence.

China's Slowdown

India has an enormous advantage in the new economic ballgame. The majority of its problems are self-created and it is in a position to address them. This creates a fantastic opportunity for India to be a positive outlier.

But before getting to a strategy for achieving outlier status, we need to look at things through a larger Asian prism. China is slowing down sharply and could possibly clock a growth rate of below 7% this year. Rising wages are whittling its competitive edge and undermining its position as a manufacturing powerhouse.

This means that international investors are likely to look at alternatives like India to relocate manufacturing bases. Thus the potential for attracting substantially more foreign direct investment is large.

How do we achieve this? A lot of the reforms that are needed to enhance India's status as an investment destination are low-hanging fruit. Take GST, which is ready to roll out, if only all the states agree to this and political parties agree on a minor constitutional amendment to allow states to tax services. The implementation of a new tax dispensation is unambiguously good for growth and revenue buoyancy. The only thing holding it back is political will and consensus.

How do you differentiate between EM assets?

Unlike in past decades, emerging markets (EM) have become diverse in terms of structure and growth performance. Hence investors have started discriminating between individual EMs on the following basis:

1 Serial Mismanagement by Authorities	2 Weak Growth Prospects	3 Legacy of Previous Booms	4 Domestic Structural Problems	5 Outlook is Now Brightening
Argentina	Turkey	Emerging Europe	Brazil	Korea
Ukraine	South Africa		Russia	Philippines
Venezuela	South East Asia		India	Mexico
	Chile		China	
	Peru			

Source : Capital Economics

WHAT NOW FOR INDIA? In times of extreme risk aversion, the EMs that are considered the weakest and most vulnerable face extreme pressure.

Given the improvement in the current account position, sentiment towards the INR and Indian assets has improved in the last 3 months. So the INR – one of the main under-performing currencies in its peer group in 2013 – has emerged as the better performing one against its peers in 2014. India needs to move from Block 4 to 5.

Despite the much discussed drop in investment spending, India managed a respectable investment rate (gross fixed capital formation) of 30% of GDP in 2012-13. The rate is unlikely to be much lower this year. What has gone completely awry though is the incremental capital output ratio (the amount of capital needed to produce a unit of GDP) that has increased from an average of around 4 in the last decade to over 6 in 2012-13.

This drop in the productivity of capital is largely the result of delays in critical sectors like power and roads. This can be resolved if there is less arbitrariness in decision-making at the central and state levels

Make Youth Work-Ready

Then there are bigger and more daunting challenges. We cannot just accept a young population as a blessing. To reap the so-called demographic dividend, we need a healthy, educated and employable population. Expenditure on health and education has to increase: we need to reach threshold levels that at least our peer economies are associated with. Public spending on healthcare in India in 2012 was just 3.9% compared with 5.2% in China and 8.9% in Brazil. It can be ramped up if the government cuts back on unnecessary expenditure like non-merit subsidies.

But simply throwing money at a problem does not solve it if the money is not spent efficiently. Progress in education cannot be measured by the literacy rate or the number of graduates. *The target is to make them work-ready or employable. Studies* have shown that of a graduate pool of about 16 million, only 25% are employable. The focus has to be on skill creation. Industry and government need to work together to ensure this.

Govt must cut back on unnecessary expenditure like non-merit subsidies

The remedy is a combination of increased spending in these critical sectors, enhanced efficiency of spending and greater collaboration between private and public sectors to find viable solutions. For the government, where does the money come from in a situation where fiscal consolidation is imperative? The answer is simple: take the subsidy bull by the horns.

Subsidies account for 18% of total expenditure and 49.5% of the total fiscal deficit. The irony is that instead of addressing this problem, we are compounding it. Take the new food subsidy bill. Even if it subsumes some of the existing programmes, it would still be a drag on the exchequer. The decision to raise the cap on subsidised LPG cylinders and de-link it from Aadhaar would also bloat the subsidy bill. This is misdirected expenditure and we cannot afford it when there are other more justifiable claims on the government.

Underpinning all this is the central issue of accountability that makes government responsible for the outcomes of its actions. Take the case of the Fiscal Responsibility and Budgetary Management Act (FRBM). While for states there are penalties for failing to comply with it, the exact penalty for the Centre busting the FRBM limits remains fuzzy. We need to devise stringent penalties for the Centre, like penal interest rates on government borrowings, when it breaches borrowing limit.

A brief comment on two of the enduring problems of the economy is perhaps in order here. Agricultural growth might have picked up but it remains highly volatile. Growth is dependent on the area under cultivation that in turn depends on the monsoon. A technological breakthrough along the lines of the green revolution is imperative. Higher yielding seeds have to be supported by the delivery of credit, power, water and the right mix of agriculture.

Glitter Like Gold

Again, despite the fact that the tightest bottlenecks are in non-cereal products, our agricultural policy is resolutely focused on cereal. The cereal-based food security programme will only buttress that further. We need more investments in the pipeline for non-cereal items.

Another problem is that of gold holdings that erode both investible financial savings and put a drag on the current account deficit. First, we must accept that there is a sociological dimension to the Indians' obsession with the yellow metal and there will always be a core demand for gold. However, offering instruments that mimic the returns on gold but are not fully backed by gold imports is one way of bringing the current account pressure under control.

The Only Risk

Finally, we must not confuse the noise of an incredibly diverse democracy in transition with the vibrancy of India. The recent developments in the political and economic scenario are welcome. We are moving towards representative democracy, which is transparent and accountable, fiscal prudence and inclusive growth.

The recent elections have served as a wake-up call to old thinking, both economic and political. We are witnessing mind-boggling change, with all sections of the population seeking to be holier-than-thou in championing performance, transparency and accountability. We can expect before May a spate of competitive legislation covering Lokpal to land acquisition, natural resources to FDI. The more noise the electorate makes, the more action that will follow.

Now comes the new election — and a new dawn. The only risk is a fractured mandate that will lead to policy paralysis and pandering to selfish interest. Barring this, our problems are on the way to resolution.

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