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Can India grow at 8 to 9 per cent?

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C. Rangarajan. Photo: V.V. Krishnan

The economy in the recent past has shown that it has the resilience to do so. But to overcome the current phase of declining investment rate, political and social cohesion is imperative.

The Indian economy is currently passing through a phase of relatively slow growth. However, this should not cloud the fact that over the nine-year period beginning 2005-06, the average annual growth rate was 7.7 per cent. Against this background, the relevant question is whether India has the capability to grow at 8 to 9 per cent in a sustained way. In short, what is the potential rate of growth of India?

Normally, potential growth is measured using trends with some filters. In one sense, these are backward-looking measures, since they depend on historically observed data. In the case of measuring capacity utilisation in manufacturing, the maximum capacity is very often taken as the maximum output achieved in the recent period. Perhaps, in the case of determining the potential rate of growth of the economy also, one can take the maximum growth rate achieved in the recent past as the lowest estimate of the potential. However, this assumption will be valid only if there is reason to believe that the maximum growth rate achieved in the recent past was not a one-off event and that the growth rate achieved was robust and replicable.

High-growth phase

India achieved a growth rate of 9.5 per cent in 2005-06, followed by 9.6 per cent and 9.3 per cent in the subsequent two years. After declining a bit in the wake of international financial crisis, the growth rate went back to 8.9 per cent in 2010-11. In many ways the growth rate achieved in the high phase period of 2005-06 to 2007-08 was robust. The domestic savings rate during this period averaged 34.9 per cent of GDP. Similarly, the gross capital formation rate averaged 36.2 per cent. The current account deficit (CAD) remained low with an average of 1.2 per cent of GDP. Agricultural growth during this period averaged 5 per cent, and the annual manufacturing growth rate was 11 per cent. The capital flows were large but as the CAD remained low, the accretion to reserves amounted to $144 billion. Inflation during the period averaged 5.2 per cent. The combined fiscal deficit of the Centre and States was 5.2 per cent of GDP, well below the stipulated 6 per cent. Thus on many dimensions the growth rate was robust. Unlike in the 1980s when the pick-up in growth was accompanied by deterioration in fiscal deficit and current account, the sharp increase in growth between 2005-06 and 2007-08 happened with the stability parameters at desired levels. Also, a booming external environment provided good support.

To assess whether the high growth phase can be replicated, we need to understand the factors that led to the slowdown since 2011-12. Complicating the analysis of this period is the revision of national income numbers with a new base. The two sets of numbers present a somewhat differing picture. According to the earlier series, the growth rate of the Indian economy fell below 5 per cent in 2012-13 and 2013-14. But the new series shows a decline below 5 per cent only in 2012-13. For 2013-14, the new series records a growth rate of 6.6 per cent, as against 4.7 per cent according to the earlier estimate. For 2014-15 and 2015-16, there is only one set of numbers, that is, according to the new series. For both the years the growth rate is above 7 per cent. These are good growth rates under any circumstance, let alone the current global situation. Anyway, we have come down from the growth rate of 9-plus per cent which we had seen earlier.

Three sets of reasons are attributed for the slowdown. First, the external environment had deteriorated sharply. The recovery from the crisis of 2008 was tepid. One country after another in the developed world came under pressure. Strangely, however, international commodity prices including crude oil prices remained high until a couple of years ago. All this had an adverse impact on developing countries, including India. However, it would be wrong to attribute the slowdown in India primarily to external factors. The domestic factors are the key. Second, there were severe supply bottlenecks. Agricultural production fell sharply in 2009-10 because of a severe drought. This triggered an inflation which lasted for several years thereafter. Coal output fell. Iron ore output fell, partly because of court decisions. The third set of reasons is basically non-economic which led collectively to a weakening of investment. A multitude of issues relating to scams and perceived delays in decision-making created an element of uncertainty in the minds of investors. New investments began to fall.

Productivity of capital

An analysis of the data of the period since 2012-13 reveals two trends. First, there has been a decline in investment rate. Second, the decline in growth rate is greater than the decline in investment rate indicating a rise in the incremental capital-output ratio (ICOR). In 2007-08, India's investment rate was 38 per cent of GDP. It declined steadily to touch 34.8 per cent in 2012-13. This is according to earlier National Income estimates. However, according to the revised estimates, the investment rate began to fall only from 2013-14. The declining trend continues into 2015-16.

With an ICOR of 4, which was what it was in the high growth phase, even the lower investment rate should have given us a higher growth than what the economy has seen since 2011-12. The rise in ICOR can be attributed to the delay in completion of projects or the lack of complementary investments. In some cases, it can also be due to non-availability of critical inputs. The delay in completion of projects can be due to internal reasons as well as policy constraints. It is here questions relating to land and environment enter. About two years ago, it was estimated that there were around 750 "stalled" projects with a total value of Rs.8.8 lakh crore. What then are the lessons that we can draw from this experience? Even with the existing level of investment rate, it should be possible to grow at 7.5 per cent in the short run, provided ways are found to speedily complete projects. However, only a return to higher levels of saving and investment can take us back to 8-9 per cent growth seen earlier. Thus what is needed to achieve the "potential" is to raise the investment rate and improve the productivity of capital.

The emphasis on the level of investment and productivity of capital as key to achieve the "potential" raises another issue of whether the Indian economy is "supply constrained" or "demand constrained". Most developing economies are generally "supply constrained". India is no exception. But there can be occasions such as the current phase in India where demand deficiency can be a critical factor. In fact, in the current situation, weakening of external demand has had an impact on manufacturing. There is no doubt that a buoyant external environment will play an important part in boosting domestic economy.

Gazing into the future

The rise in investment rate must be supported by a rise in the domestic saving rate. An increase in investment rate supported by a widening current account deficit is not sustainable and is fraught with serious consequences. Only a current account deficit in the region of 1 to 1.5 per cent is sustainable. Incremental capital output ratio is a catch-all variable which is influenced by a host of factors. Obviously, it depends on technology. It also depends upon the skill of the labour force which in turn depends on the quality of the education system. Another catch-all expression "ease of doing business" is also relevant. Bureaucratic hurdles which impede speedy execution of projects need to be removed. Thus improving the productivity of capital needs action on several fronts.

Making a prediction about the future is always hazardous. Many things can go wrong. The Indian economy in the recent past has shown that it has the resilience to grow at 8 to 9 per cent. Therefore achieving the required investment rate to support such a high growth is very much in the realm of possibility. However, we need to overcome the current phase of declining investment rate. Investment sentiment is influenced by non-economic factors as well. An environment of political and social cohesion is imperative. Equally, we can get the ICOR back to a lower level. Raising the productivity of capital will require policy reforms including administrative reforms as well as firm-level improvements. The "potential" to grow at 8 to 9 per cent at least for a decade exists. We have to make it happen.

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