

India can sustain 'miracle' GDP growth of 7%. There is only one rider

Synopsis

This will, of course, require reforms in education, infra, finance, and the police-judicial system. Much depends on global trends, which affect India more than most people imagine.



**Swaminathan S
Anklesaria Aiyar**

Consulting Editor, The
Economic Times



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GDP growth crashed to just 3.7% in the pre-Covid year 2019-20. In the preceding two decades, GDP growth averaged over 7% (save in the Great Recession of 2008-09). Pessimists such as Shankar Acharya note that GDP growth slowed steadily from 2016-17 onward, and the sharp fall in 2019-20 simply confirmed the emergence of a new era of much lower growth, maybe just 5% annually. However, optimists viewed the 2019-20 crash as just a temporary blip.

The blip year has been followed by two years of **Covid** and now the Ukraine war. That muddies all analyses. Only after conditions normalise will we know whether GDP growth has shifted to a slower trend. A new National Council of Applied Economic Research (NCAER) paper by Poonam Gupta and Abhinav Tyagi provides an optimistic analysis, concluding that 2019-20 was a blip.

The researchers say annual GDP growth for the three pre-blip years was 8.3%, 6.8%, and 6.5%, and then fell to 4% in the blip year (which has recently been revised by the National Statistical Office to 3.7%). The researchers conduct a quarter-by-quarter analysis of the four years and find no clear slowdown before March 2018. Hence they reject the pessimists' thesis of a multi-year slowdown.

In the blip year, agricultural growth at 4.3% was faster than in the preceding years. Services growth at 7.2% was not far below the earlier average of 8.2%. But manufacturing growth crashed from 7.3% to -2.4%. This does not look like an economy-wide problem. It looks more a blip confined to industry.

The researchers consider and reject other possible causes of the slowdown such as macroeconomic excesses, terms of trade shocks, tightening of fiscal or monetary policy, a sudden stop in capital flows, aggravated policy, or political uncertainty. This leaves three important explanators: trade, Covid and the financial sector.

Indian exports fared brilliantly when world trade boomed by 10% annually between 2001 and 2012. But world trade decelerated to just 1.5% annually between 2012 and 2018. In the blip year, it fell further to -1.5%. India's growth of goods and services exports followed a similar pattern, averaging 4.6% in three years before the blip year and then falling to -3.3%. So, India's blip was part of that global blip rather than a new India-specific trend.

Party Poopers

Covid arrived at the tail end of 2019-20. The researchers estimate this cut GDP growth by 50 bps while falling exports cost another 120 bps.

The third problem in the blip year was the financial sector. Infrastructure Leasing & Financial Services (IL&FS), a giant non-banking finance company (NBFC), went bust with a knock-on effect on the entire financial sector. The Punjab & Maharashtra Co-operative Bank and Dewan Housing Finance also went bust after scams. These spectacular busts dampened all credit, including for industry and exports. NBFC credit growth slowed from 18% a year between 2013-14 and 2018-19 to 7% in the blip year.

The researchers believe financial slowing hit manufacturing growth dramatically. This is not convincing. Since finance belongs to the services sector, financial slowing should have hit services more than manufacturing. Since the scams reduced services growth so modestly - from 8.2% to 7.2% - could they really be the main cause for manufacturing growth plummeting from 7.4% to -2.4%? The truth is we don't have a good explanation.

Behold the Miracle?

Economists like Rakesh Mohan have long stressed the importance of exchange rates in promoting exports. The boom export era of 2003-2012 was helped by the Reserve Bank keeping the real effective exchange rate (REER) stable. But subsequently, exports were hit by an appreciating REER. Measured by RBI's 40 currency basket, the REER appreciated from 90 at end 2013 to 106 in early 2018. It then stabilised at around 103 in March 2020, the end of the blip year.

In the subsequent two years, the REER has remained essentially unchanged.

That must be one reason for India's huge export surge in 2021-22.

Merchandise exports had stagnated at around \$300 billion annually since 2012, but shot up by 44% to \$420 billion in 2021-22. This was part of a global trade boom estimated at 25% by the United Nations Conference on Trade and Development. India's rate was much higher. This will doubtless decelerate in 2022-23. Yet it torpedoes earlier fears of medium-term export stagnation.

This is the best evidence for growth optimism. Exports growth will doubtless be slower this year because of the Ukraine war. But if India can achieve export growth of 12-15% annually, then a 'miracle' GDP growth of 7% looks sustainable. It will, of course, require reforms in education, infrastructure, finance, and the police-judicial system.

Much depends on global trends, which affect India more than most readers imagine. Ruchir Sharma has focused on the 4Ds - de-globalisation (shrinkage of global trade and investment), de-population (shrinking working-age population in most countries), deleveraging (countries and corporates seeking to reduce their debt/asset ratios) and de-democratisation (autocracies on an average perform worse economically than democracies). He thinks these factors will depress world productivity and growth, and India will suffer too.

I think such fears are legitimate, but exaggerated. The jury is still out on this one. The optimists have a decent case.