CHAPTER 10
INDIA

Introduction. The 9-11 terror attacks on the United States and a global slowdown are shocking India's economy.

- In September India's stocks crashed 20% in a ten day period and reached an eight-year low.
- The already weak industrial sector went into reverse gear. Industrial production fell in one sector after another.
- Exports plummeted and consumer confidence went south.

Growth Slows. Overall, GDP is slowing down sharply.

- Predictions that the economy would grow by 6% this year are dead.
- Even before 9/11, growth was slowing down well below last year's 5.2%. Real GDP rose only 4.4% in the year to 2Q01.
- But growth is in a downturn the rest of 2001 and may even contract in 2002.
- Despite historically-rising trade, imports persist in exceeding exports, thereby draining the economy. (See Figure 10-A.)

Rising Jobless Numbers. The impact of this painful downturn is now being felt up close and personal, as urban Indians lose their jobs and recruitment dries up.

- Every sector has been affected, from banking to steel making.
- Millions are facing voluntary retirement schemes.
- And fewer new recruits are needed.

Idle or Closed Businesses. Many Indian factories are in the throes of a crisis.

- In Rajasthan, ball bearing factories are idle as orders disappear. 11 out of 15 ball bearing factories are without work.
- Two out of five industries are closed or are on the verge of closing.
- At least one-third is set to report a sharp dip in their fortunes.
- About one-third say production and sales are down compared to 2000.
- 40% expect to see a decline in exports.

Figure 10-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	357.4	421.3	442.2	479.4
Purchasing Power	1599.0	1665.4	2144.1	2443.2
Real Growth (%)	4.9	5.8	6.8	6
Inflation (%)	7.2	13.2	4.7	4.0
Exports	35.8	33.9	37.1	44.9
To U.S.	7.7	8.7	9.6	11.0
Imports	42.5	43.2	50.1	50.6
From U.S.	3.6	3.5	3.7	3.7
FDI from U.S.	1.7	1.5	1.4	1.3
In U.S.	0.1	0.1	0.1	0.1
Cur Account /GDP %	-1.3	-1.0	-1.0	-0.5
Fiscal Balance /GDP %	-4.8	-5.1	-5.5	-5.1
External Debt /GDP %	23.3	23.5	21.3	..

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 10-B

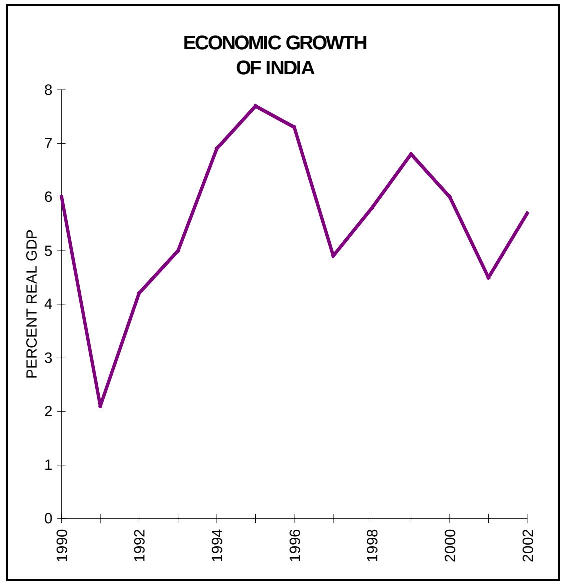
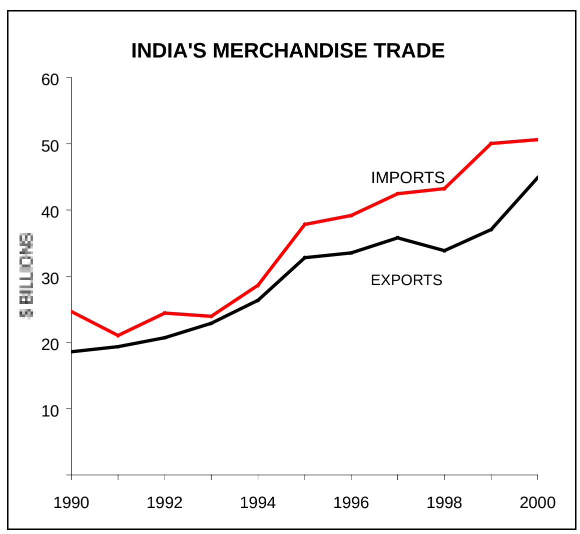


Figure 10-C



Industrial Casualties. Which industries have been hardest hit?

- The once booming automobile, consumer electronics, and consumer durable sectors are reeling.
- Industries like aluminum and steel are also in a precarious situation.

Tourism Drops. In addition, the air-travel and hotel industries have predictably been badly hurt since 9-11.

- The tourism season in India—which peaks between October and March—has ended even before it began. Almost 50% of bookings have been cancelled.
- The average occupancy rate in some leading hotels is currently at 25-30%. This is in sharp contrast to the normal occupancy rate upwards of 65% for this time of year.
- With U.S. Afghan intervention, the industry was virtually closed for the season.

Terror's Information Technology (IT) Toll. 9-11 also accelerated the downward spiral of the star of India's economy, the previously booming IT sector, which accounts for 2% of GDP.

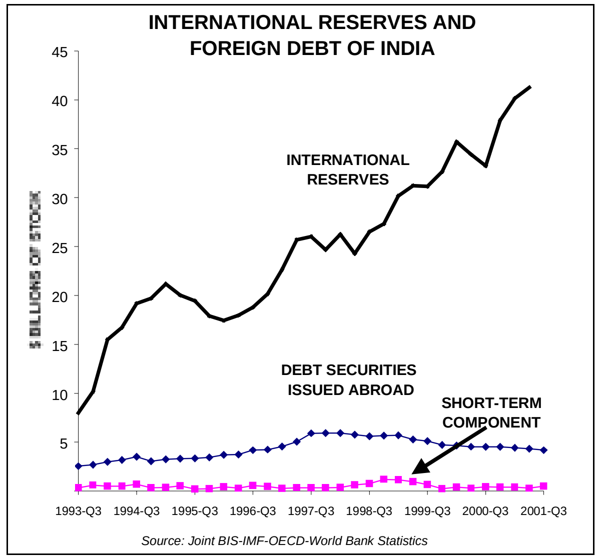
The Rise of IT. Thanks to the big presence in U.S. markets in recent years, the Indian software services sector had seen its exports to the United States boom.

- That in turn played a vital role in driving Indian economic growth.
- IT exports also helped maintain a healthy foreign exchange reserves position, which currently stands in excess of $40B. (See Figure 10-D.)

Software Scare. Unfortunately, India's software industry is now experiencing a severe slowdown.

- Even before 9/11, U.S. firms started to cut their IT spending.
- Faltering demand for Indian IT products accelerated as the U.S. economy slowed, thus hammering the bottom line of Indian IT firms.
- Software exports used to grow at 50% annually, but are likely to slip to 20% in 2001-2002.
- Demand for software professionals has plummeted. Software recruitment has fallen 30% to 50%. The job market has never been so bad for IT job seekers as it is today. The IT job market shrank by up to 25% in 2001.

Figure 10-D



Good News. That said, the Indian economy is resilient and should be able to recover from the present crisis.

- After all, this is not the first time there has been a conflict in the region. In fact, India itself has been involved in many wars in the recent past.
- The country also has a lot of experience of natural calamities and knows how to deal with destruction.
- In addition, the Indian economy is still fairly inward looking.

Primacy of Agriculture. In this regard, strong domestic sectors—such as agriculture—remain insulated to some extent from the goings on in the rest of the world.

- Agriculture remains the vast heart of the country's economy, encompassing 25% of GDP and about two-thirds of India's population.

- While weak monsoon rains hurt agricultural growth in 1999 and 2000, the rain gods were kinder in 2001.
- Another encouraging sign is the sharp growth in the amount of land used to grow crops. The number of acres of rice, India's most important food grain, has risen by 11% from the same time in 2000.
- As a result, the growth of agricultural production is expected to continue.

Fiscal Crisis. That said, India has daunting problems on the structural side of its economy. In particular, India faces a looming fiscal crisis.

- The combined central and state government fiscal deficit is 9.9% of GDP.
- Given the Maastricht rule of thumb for financial stability—that budget deficits should be below 3% of GDP—India's budget deficit is cause for alarm.
- Worse still, the government shows no real sign of controlling the budget deficit.

Why a Fiscal Threat? The ballooning fiscal deficit puts pressure on long-term interest rates.

- Higher real interest rates choke off long term growth by crowding out private investors.
- Since more than half of central government expenditure is consumed by interest payments, defense, and hand-outs to states, many worthwhile public investments in education, health care, and new infrastructure are crowded out.

Investment Shortfall. New investment is needed now that most of the capacity put in place during the exuberant early 1990s has been used up, and efficiency gains from earlier reforms are running out of steam.

- Unfortunately, the government or private sector lacks the resources to put anything like the $30B to $40B a year into infrastructure that India desperately needs for high, sustainable growth.
- In order to generate the accelerated economic growth that in turn could ultimately lift almost 400 million Indians (or 40% of the population) out of poverty, India needs a second generation of deeper and more comprehensive economic reforms. Is political will there?

Political Buildup. Atal Behari Vajpayee's was re-elected as head of a coalition with an ostensible majority—the first sitting Prime Minister returned to power.

- Vajpayee's re-election raised hopes of a new wave of economic reform after the tentative liberalization of the early 1990s.
- Armed with more political clout, Vajpayee finally had a fighting chance to revive India's stalled economic reforms.
- In anticipation of these economic reforms to invigorate the economy, the Indian stock market soared.
- But hopes and high expectations were quickly dashed.

Political Letdown. After an initial burst of passing long-shelved economic measures, there has been almost no forward movement on economic reforms. And with the early momentum lost, Vajpayee faces mounting political criticism from two directions:

- From foreign investors and from his own ranks for not advancing economic reforms aggressively enough.
- From Sonia Gandhi, the Congress leader, who is starting to repudiate the reforms.

Modest Reforms. To be fair to Vajpayee, some economic measures have emerged:

- After seven years of debate, the insurance market was recently opened to private and foreign investors.
- It's getting easier for Indian companies to acquire foreign partners in areas such as pharmaceuticals and mining, as well as to raise capital abroad as foreign exchange restrictions are loosened.
- The government gave up its monopoly on long-distance telephone access and access to the international bandwidth to the Internet—measures that are crucial to the continuing success of India's booming informational technology industry.
- India dismantled the last of its quantitative restrictions on imports.

Unfinished Reform Agenda. But much more must be done. To boost long term economic growth, India must:

- Upgrade its abysmal infrastructure, especially the collapsing and bankrupt power generation system.
- Improve education to reduce the high rate of illiteracy.
- Improve the inefficient legal system.
- Privatize inefficient state-run enterprises.
- Introduce market-linked user charges for public goods and services such as electricity and water.

Toward Policy Goals. These measures would help India reach a number of policy goals:

- Bring down a level of subsidies amounting to about 15% of GDP.
- Reduce the fiscal deficit.
- Enable more spending on primary health, education, and new infrastructure.
- Boost literacy from a low of 62% of 1B population.
- Save the 1.5 million children the World Bank estimates die each year from waterborne disease.

Slow Sell-offs. The government says it intends to reduce the budget deficit by privatizing the loss-making state enterprises.

- Mr. Sinha, India's finance minister, promised to raise 120B rupees ($2.5B) from privatization in 2001.
- But the government would do well to reach half that figure. The privatization program is falling well below the sell-off target. Fact is, the government has not sold a single company this year. That's not good enough.

McKinsey Report. In a report on India's economy, McKinsey Global Institute underscores the importance of:

- Privatization (cited above),
- Clearing barriers that stifle product development investment, and
- Removing distortions to the property markets.

By taking these three steps, the McKinsey study says India could double its economic growth rate to 10%.

Privatization. Excessive government ownership of Indian industry subtracts 1.4% from India's GDP.

- Almost one-half of India's productive assets are under government control.
- India is probably the most government-controlled of any serious economy in the world.
- India's investment rate is limited to a much lower level than it could be.
- If the government accelerated privatization, India's investment rate would rise from just 24% of GDP to more than 30%.
- For example, India's state-owned electricity companies waste 40% or more of their power, while private distributors lose just 10%.
- Subsidies to these loss-making electricity companies cost 1.5% of GDP—an opportunity cost that could be used for more productive investment elsewhere.

Low Productivity. India's labor productivity is also constrained by loss-making and inefficient state ownership. McKinsey says that India's labor productivity is just:

- 8% of U.S. levels, and 50% of Russia.
- In a dozen “modern” sectors, labor productivity is 15% of the American rate. It is as high as 44% of American levels in software. But it's as low as 1% in electricity distribution.
- McKinsey calculates that labor productivity can double to 8% a year and capital productivity can increase by 50%.

Product Market Barriers. McKinsey says the complex web of regulations and licenses that govern India's products cut as much as 2.3% a year from the country's GDP.

- These barriers include such well-known obstacles as the restrictions on the size of companies making 800 different products.
- India also bans foreign investment in retailing, which keeps consumer prices artificially high and restricts growth.

Property Market Distortions. McKinsey says that land market distortion reduces economic growth by 1.3% a year.

- 90% of India's land titles are under legal dispute. Since potential investors cannot get clear title to land, they do not make long-term investments in that land. Presently, it will take more than 100 years to resolve land titles under dispute.
- This uncertainty severely hinders the incentive for land developers to invest in retail or housing.
- As a result, India has by far the highest property prices in Asia relative to income.
- Just 1% of the workforce is employed in residential construction, compared with 5% or 6% in more developed economies.

Obstacles. Of course, implementing McKinsey recommendations and other economic reforms cited above won't be easy.

- Despite a majority in parliament, the stalled economic reforms of the BJP-led government are still threatened by fractious politics. The politics of economic reform in a democratic country divided by caste, community, and regional identity are often frighteningly intractable.
- In other words, an economic strategy for India does not occur in a social and political vacuum.
- Therefore, the government's ability to take politically painful decisions necessary for more fundamental reforms will likely be hampered by resistance from coalition members wanting to protect their vested interests.
- That translates into a strong political consensus in favor of weak economic reforms and enormous political pressures against strong reforms.

***Changing a Mindset**.* Economic change in India not only involves changing laws and institutions. More importantly, it involves changing the way people think about their attitudes and belief systems.

- There is a strong perception that economic reform loses votes. So the tendency is for Indian leaders to opt for marginal, incremental change.
- Yet only bold economic reforms will significantly reduce poverty in India anytime soon. Indian Finance Minister Yashwant Sinha supports this position and says, "One has to be ready to take hard (economic) decisions… You pay a much bigger price ultimately for exercising softer options."

Wanted: Clear Message. Vajpayee and his stable of economists must develop and sell a clear message to the Indian people.

- The message: Stronger economic reform is the only way to bring higher growth rates, improve standards of living, and provide the much needed funds for education, health care, and infrastructure.
- Unfortunately, the government has been unable to articulate a clear and persuasive case for structural economic reform.
- Delhi must explain how it could benefit ordinary people and begin to lift 350 million Indian—who live on less than $1 a day—out of their misery.

Conclusion

9-11 shocked a languid Indian economy. Growth is less than potential, unemployment is rising, and corporations are going out of business. Even the IT sector is reeling. The good news is that India's resilient economy—strong in domestic sectors such as agriculture—should help drive a recovery following the crisis.

The bad news is that the government shows no sign of addressing an alarming budget deficit, which is triggering a fiscal crisis. If India is ever to reduce poverty, it must deepen its economic reforms.

In this regard, the McKinsey study shows how GDP would double if India privatized and removed barriers in product and property markets. Unfortunately, the social and political obstacles to such reforms are formidable.