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NOT BY WISHFUL THINKING

Relevant for: Indian Economy | Topic: Issues relating to Mobilization of resources incl. Savings, Borrowings & External Resources

In early June, at a NITI Aayog meeting, Prime Minister Narendra Modi set a clear and bold economic target — to grow India into a $5 trillion economy by 2024. It is now for ‘Team India’, as the meeting was bannered, to translate this target into a plan and policies and programmes. Historically, such goals by popularly elected leaders have voiced the aspiration of voters and energised nations to realise their potential.

What does the targeted $5 trillion economy mean in familiar economic terms? It is 350,00,000 crore of gross domestic product (GDP) at current prices, at 70 to a U.S. dollar exchange rate. India’s (provisional) GDP in 2018-19 at current prices is 190,10,164 crore (or $2.7 trillion), which means the annual per capita income is 1,42,719, or about 11,900 per month.

The target implies an output expansion by 84% in five years, or at 13% compound annual growth rate. Assuming an annual price rise of 4%, in line with the Reserve Bank of India’s inflation target, the required growth rate in real, or inflation-adjusted, terms is 9% per year. To get a perspective, India officially grew at 7.1% per year over the last five years, but the annual growth rate never touched 9%. Hence, the target seems ambitious. Is it doable?

How does the target compare with the Asian experience? China, with a historically unprecedented growth record in its best five years, during 2003-07, grew at 11.7%; South Korea, between 1983 and 1987, grew at 11%. So, Mr. Modi’s target is smaller than the best historical records and may seem realistic.

What would it take to grow at 9%? No country grew at such a pace without mobilising domestic saving and raising fixed investment rates.

In the last five years, on average, the domestic saving rate was 30.8% of gross national domestic income (GNDI), and the investment rate (gross capital formation to GDP ratio) was 32.5%. Assuming the underlying technical coefficients remain constant, a 9% annual growth rate calls for 39% of domestic saving rate and 41.2% of investment rate. Correspondingly, shares of private consumption need to shrink to about 50% of GDP from the current level of 59% of GDP at current prices, assuming foreign capital inflow remains at 1.7% of GDP.

In other words, India will have to turn into an investment-led economy as it happened during the boom last decade (2003-08) before the financial crisis, or like China since the 1980s. Granting that rapid technical progress or changes in output composition could reduce the required incremental capital-output ratio (ICOR), it nevertheless will call for a nearly 8-9 percentage point boost to saving and investment rates.

If, however, the economy has grown at a much slower pace than the officially claimed rate — as the on-going GDP debate suggests and at 4.5% as the former Chief Economic Adviser Arvind Subramanian has pegged it — then Mr. Modi’s growth target would become even more daunting.

These stark facts call for a re-thinking in the ruling dispensation that seems to hail India as a consumption-led growth story. There is a belief that greater foreign capital (FDI) inflow would fill in the investment gap, as evident from the NITI Aayog Vice-Chairman’s various pronouncements. History shows that no country has succeeded in accelerating its growth rate

without raising the domestic saving rate to close to 40% of GDP. Foreign capital can fill in some vital gaps but is not a substitute for domestic resources. Even in China, FDI inflows as a proportion of GDP never exceeded 5-6%, most of which was in fact round-tripped capital through Hong Kong for securing better property rights at home.

Gross FDI inflow into India peaked in 2008-09 at 2.7% of GDP, decelerating thereafter. As it increasingly consists of private equity (PE) with a three- to five-year tenure, mostly acquiring capital assets (contrary to the textbook FDI definition as fixed capital formation for the long term) net FDI rate is lower than the gross inflows, standing at 1.5% of GDP in 2017-18. Hence, there is a need for caution against the exuberance (or opportunistic bias) that FDI will help to get to the $5 trillion GDP target.

What is serious is that the economy has slowed down for a while now. The domestic saving rate has declined from 31.4% in 2013-14 to 29.6% in 2016-17; and gross capital formation rate from 33.8% to 30.6% during the same period. The banking sector's ability to boost credit growth is limited by non-performing assets (NPAs) and the governance crisis in the financial sector. Export to GDP ratio has declined rapidly, with a looming global trade war on the horizon, as has been indicated by the Baltic Dry Index. The highly regarded leading indicator of global trade, currently trading at 1354 is forecasted to decline to less than 1,000 index points by the year-end (a decline from its historic high of 11,793 points in May 2008, just before the financial crisis set in).

Given the foregoing, the $5 trillion target appears daunting. It may yet be doable, provided policymakers begin with a realistic assessment, by willing to step up domestic saving and investment, and not by the wishful thinking of FDI-led growth accelerations in uncertain economic times.

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