

India's Post-Crisis Reality Check

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India sailed through the Great Crisis of 2008–09 without barely skipping a beat. But celebration may be premature. As the aftershocks in Southern Europe suggest, the post-crisis world is likely to remain a very treacherous place for some time to come. Although India has one of Asia's most balanced—and therefore, resilient—macro structures, it can ill afford to ignore ever-present stresses and strains in the external environment. For India, the crisis and its aftermath should be viewed as a wake-up call—a time to sharpen its focus on the challenges and opportunities shaping its development journey.

While resilient, India was hardly unscathed by the recent crisis and recession. However, its downside was far better contained than in the developed world. Industrial production troughed out in positive growth territory—barely, to be sure, at +0.3% in early 2009—and real GDP still managed to expand by +6.7% in FY2009. In both cases, these were major downshifts relative to vigorous pre-crisis growth trajectories. But against the backdrop of a world that had tumbled into the deepest recession since the 1930s, India's relative resilience was especially impressive.

While resilient, the Indian economy was hardly unscathed by the Great Crisis of 2008–09. A rapidly expanding export sector was hit hard by a massive shock to external demand and global trade.

India also fared well compared to others in the developing world. Unlike China, where the external demand shock

posed a major threat to jobs and social stability, India's more measured policy actions did not have destabilizing post-crisis repercussions that resulted in property bubbles and deteriorating bank loan quality. Nevertheless, India followed the pack and shifted its monetary and fiscal policy levers into unusually stimulative positions—actions that are not without attendant risks to underlying inflation.

In this regard, India now faces the same dilemma as others—how to orchestrate an effective “exit strategy” from the emergency policies that were put in place during the crisis. And the exit strategy needs to be executed in what still looks to be a very shaky post-crisis global climate. At the same time, these delicate policy maneuvers must be crafted in a fashion that preserves India's ongoing development program. This is no easy feat for any nation.

With Europe India's largest trading partner, the ongoing repercussions of Europe's sovereign debt crisis could be an important headwind buffeting the Indian economy for the next several years.

While the Indian economy has better balance than others in Developing Asia—namely, a greater portion going to private consumption and services and less to exports and investment—India is hardly immune to shocks elsewhere in the world. To be sure, the export share of the Indian economy was only 24% in 2008—far short of the 45% norm for Developing Asia as a whole. However, India's 2008 export share was more than double the 10.8% reading in 1998. At the margin, the delta (i.e., change) in India's export share—rather than its level—is what drives economic growth. Little wonder that on the heels of a crisis-induced collapse in global trade, growth in Indian industrial production plunged from about 13% in early 2007 to around “zero” in early 2009.

There is, however, an important twist to India's increased exposure to external demand. In recent years, the composition of Indian exports has shifted dramatically away from the developed world toward its neighbors in Developing Asia. The US share of Indian exports was cut in half—falling from 22.8% in 1999 to 11% in 2009—whereas the share going to Europe slipped from 27.6% in 1998 to 20.9% in 2009. Meanwhile, the portion going to Developing Asia essentially doubled from 5.6% in 1999 to 11.6% in 2008. While these shifts in the mix of Indian exports underscore a lessening growth impetus from developed markets and an increased reliance on demand from Developing Asia, they hardly eliminate India's vulnerability to lingering problems in Europe.

The good news is that even with sharp recessions in Greece, Portugal, and Spain—likely outcomes in response to EU- and IMF-imposed fiscal consolidation in all three countries—shortfalls in pan-European economic growth are likely to fall well short of the severe crisis-induced contraction that occurred in late 2008-09. The bad news is that even with recent significant shifts in the mix of India's external demand, Europe remains its largest export market. On balance, the ongoing repercussions of Europe's sovereign debt crisis could well be an important headwind buffeting the Indian economy for the next several years.

Lingering post-crisis aftershocks make it all the more critical for India to redouble its efforts on other aspects of its development strategy. Key in that regard will be to sustain the recent improvement in domestic saving. India's gross domestic saving rose to 36.4% of GDP in FY2008—up sharply from the subpar readings in the low 20s that had prevailed since the early 1990s and a major support to India's recent increases in investment spending on both infrastructure and manufacturing capacity. However, on the heels of a sharp crisis-related increase in the government budget deficit, the domestic saving rate fell back to 32.5% in FY2009—a downturn that must be reversed if India is to stay the course of investment-led growth.

India needs to implement a post-crisis exit strategy—with monetary policy normalization required for inflation control and fiscal policy consolidation aimed at restoring domestic saving to pre-crisis norms.

Therein lie the pitfalls of the “exit-strategy trap.” Like most major economies, India is having a hard time restoring its policy settings to pre-crisis norms. Despite the impressive post-crisis rebound of the Indian economy—underscored by a sharp 8.6% y-o-y increase in real GDP growth just reported

for the quarter ending March 2010—the Reserve Bank of India has unwound only 50 basis points of the 425 bp easing that was implemented during the crisis. While there are hints of more rate hikes to come, the RBI has yet to convert these hints into action. With non-food inflation on the rise both at the wholesale and retail levels, prolonged monetary accommodation is both inappropriate and worrisome.

Moreover, the government's latest budget points to limited reduction in the structural deficit in the current fiscal year—with the bulk of any improvement stemming from one-off windfalls associated with divestments and 3G license fees. More meaningful fiscal consolidation is slated for 2011–12—deferred promises that most governments invariably have a tough time living up to. India, of course, is hardly alone in clinging to crisis-like policy settings. That's very much the case across the developed world and in major economies of the developing world—notably China.

Sustained improvement in domestic saving is essential if India is to resume the investment-led development strategy focused on infrastructure and expanded manufacturing capacity.

For an emerging economy like India, a delayed exit strategy spells potential risks to core development strategies. Key in this regard are fiscal-policy-induced impediments to national saving—and the major constraints these impediments may have on spending for infrastructure and manufacturing capacity. On the heels of the recent surge in domestic saving, the corporate investment share of Indian GDP trebled in the seven years before the crisis—rising from around 5% in early FY2001 to 16% in FY2008 before falling back to near 13% in FY2009. If the crisis-induced fiscal stimulus remains in place for too long and the recent shortfall in domestic saving continues, the renewed widening of nation's current account deficit is likely to persist. That could make it very difficult for India to restart its investment-led growth dynamic.

Large and rapidly growing developing economies like India and China cannot afford to take the lead from the West and cling too long to crisis-induced emergency policies. Deferred exits strategies are not without destabilizing consequences. China has already had to come to grips with a property bubble and India may well be facing impediments to its ambitious infrastructure and capacity expansion programs. Surviving the crisis was one thing. It's now time to face up to a post-crisis reality check.

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