India’s economy: Shooting star or sprinter?

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Speaking at LSE, Dr Arvind Virmani argued that India has the capacity to resume high levels of economic growth, but only if the government implements policies to remove bottlenecks and address supply constraints.

India’s GDP growth rate slowed to 6.5 per cent in 2011-12, down from 8.4 per cent in the previous two financial years. The Indian rupee, meanwhile, is at an all-time low. At a recent talk at LSE, Dr Arvind Virmani, an executive director at the International Monetary Fund, argued that global concerns about an Indian slowdown constitute nothing more than media hype. While acknowledging that the probability of a euro meltdown in the near future would impact the Indian economy, Virmani suggested that emerging market economies, including India, have the policy space and ability to minimise the effect of such a crisis and resume growth. To make his argument, Virmani drew a distinction between accelerating and sustaining growth and stated that, at this point, India need only do the latter. For this, however, he pointed out that urgent policy actions are required to remove bottlenecks to growth, eliminate rent-seeking and reduce supply constraints.

Virmani put forth the ‘J curve of growth’ theory to show that India’s growth prospects are more stable than they seem. He sees the Indian economy as having unfolded in three phases. In the first phase, India maintained a 1.3 per cent per annum growth rate from 1951 to 1979. In the second phase, reforms of the 1980s, including gradual decontrol and import liberalisation, tripled India’s per capita growth rate to about 3.7 per cent per annum between 1980 and 1991. In the third phase, extensive economic reforms in the 1990s doubled the growth potential of the Indian economy up to 7.5 per cent per annum. However, this growth was not clearly visible in the aggregate data during the 1990s, and did not fully register until 2006. Virmani explained this delay through the ‘J curve effect’, which demonstrates that there is a time lag before economic reforms take effect owing to changes in relative prices, the decreasing competitiveness of certain industries and the time needed for new technologies to spread.

Based on this theory, Virmani argued that the current Indian economy has a higher underlying growth rate than the figures imply and that there is still time to put the economy back on track for a sustained per capita GDP growth rate of 7 to 7.5 per cent. To do this, the Indian government would have to remove various bottlenecks and facilitate drivers of equitable economic growth.

As a start, Virmani suggested learning from the examples of what he terms high growth economies (HGEs)—economies that have grown at seven per cent or more for longer than one decade. Virmani's research shows that the historical trend is for poor decadal correlation; in other words, countries that enjoy high growth rates in one decade rarely show similar growth the following decade. Since the 1960s, only 19 countries have proved to be HGEs; of these, eight were Asian countries and one-third were resource rich. Only three countries – China, Myanmar and Equatorial Guinea – still count as HGEs and continue to grow at seven per cent or more. According to this formula, India counts as a potential high growth economy (pHGE) since it has demonstrated a growth rate of six per cent or more for more than one decade.

Virmani believes that India can learn from HGEs that seek to sustain, rather than accelerate, a high growth rate. Speaking at LSE, he argued that rather than introduce "big bang" reforms aimed at sparking growth, India needs to learn how to deal promptly and pragmatically with the negative effects of exogenous shocks such as the euro crisis. The Indian government also needs to address the problem of supply chain bottlenecks resulting from incomplete reforms. Moreover, Virmani emphasised the need for the Indian government to initiate a process of institutional reforms to manage high growth; as he put it, institutional inertia can produce a "hopelessness", which in turn has a negative effect on investment, making the need for reform more urgent.

Given that growth itself creates new imbalances, Virmani also stressed the urgency of addressing broader political economy challenges. Among the issues he listed as requiring urgent policy action are conflicts over land acquisition, mining rights and better legislation on leasing natural resources.

In this context, Virmani also argued that government policies often prove ineffective because they fail to identify the correct source of the problem. By way of example, he discussed India's rising food prices, which are exacerbated by the prevalence of fragmented supply chains that cannot cope with the demands of distribution. Virmani also tackled the issue of poor social mobility and highlighted the need to keep worker skills relevant and cutting-edge. Finally, Virmani acknowledged the negative impact of rent-seeking and rampant corruption, describing these practices as the greatest source of income inequality in India.

Notably, Virmani claimed that none of India's many problems is insurmountable in the face of timely and effective policy planning. He urged the Indian government to think of these challenges as the "black lining of a silver cloud": once tackled through policy actions, India's myriad bottlenecks and supply chain shortcomings should not limit the country's ability to maintain high rates of economic growth for consecutive decades.

Dr Arvind Virmani is Executive Director at the IMF and Affiliate Professor, George Mason University. Previously, he has advised the Indian government for 25 years in various positions, including Chief Economic Advisor.

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