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INDIA – READY TO STEP INTO CHINA'S SHOES?

Global Macro Matters

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India—Ready to Step into China's Shoes?

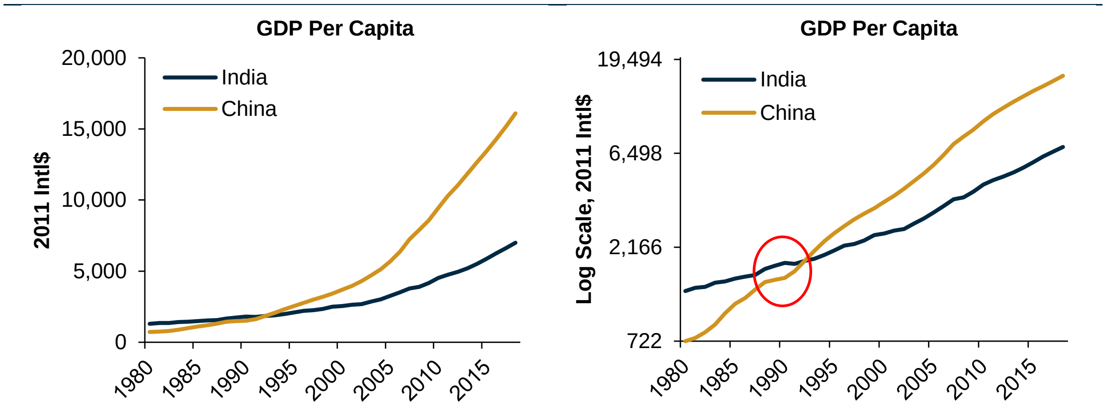
The confluence of the resounding victory of Prime Minister Modi and his pro-business vision for India, with the once-again escalating trade tensions between the U.S. and China, have rekindled interest in India assuming the export-powerhouse baton from China and shifting up a gear in its long-term growth potential.

This paper outlines why that task may not be as daunting as it seems at first glance, especially when it is kept in mind that India's relative underperformance compared to China is a rather recent phenomenon. It is only the strong reforms in China just three decades ago that set the stage for its subsequent surge.

This background holds lessons for India at present. Importantly, larger macroeconomic savings and economy-wide productivity are the essential ingredients for a successful shift of India's growth model. Though the overall policy vision of the government is well aligned with these requirements, actual policy measures—especially essential fiscal consolidation and more efficient and competitive markets—still need to be implemented, or even formulated in some circumstances. Once they are in place, growth in India could surprise many skeptics.

Observers commonly discuss both India and China as unique *sui-generis* cases, highlighting their differences and idiosyncrasies that presumably make them incomparable to one another, as well as to third countries. While there is some merit in this approach, it unfortunately precludes gathering relevant applicable lessons from each other's experiences, especially if the issue at hand concerns general macroeconomic questions like economic growth and inflation. In contrast, in the following, we focus on the similarities between India's and China's recent economic histories and ask whether China's spectacular rise over the last three decades holds relevant lessons for Indian policy makers today.

Figure 1: While China by now has a much larger per-capita income than India, this development was ushered in only some 25 years ago, when China's reform drive re-accelerated.



Source: International Monetary Fund as of December 31, 2018.

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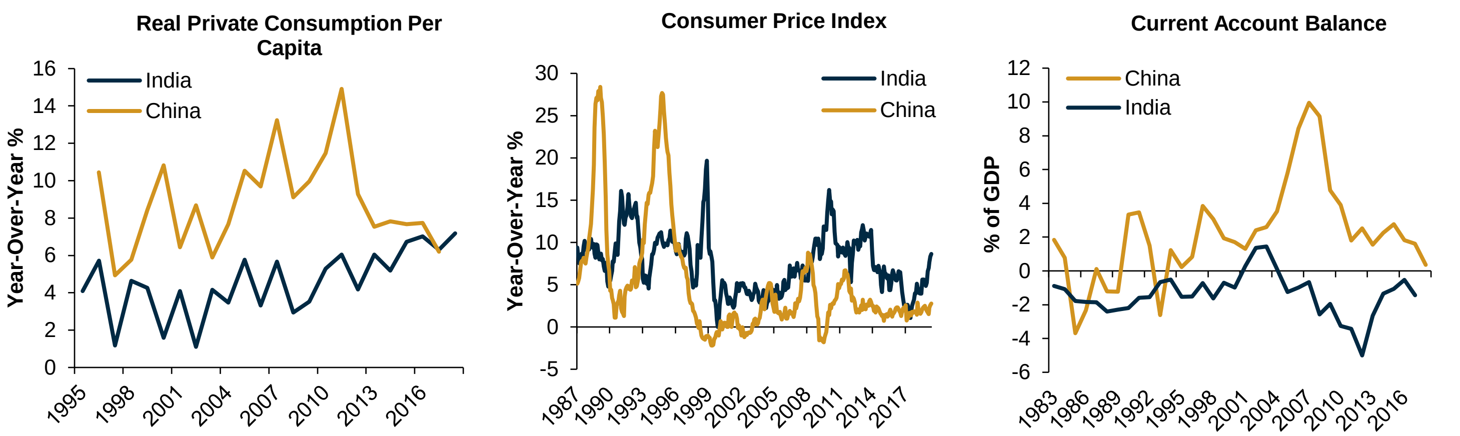
A Bit of History—India Has Not Always Lagged

While the rise of China has been truly historic, it is not that long ago that India was the richer economy. Indeed, in the early 1990s, i.e., less than 30 years ago, India outperformed China on per capita income, inflation, and current account. The critical differentiation in the subsequent growth trajectory occurred back in the early 1990s when the gap in per-capita income had narrowed and its growth rates converged to similar levels (the parallel slopes in the right-hand chart of Figure 1, which is on a logarithmic scale). While for India, this performance remained in line with trend, for China, this episode marked a pronounced slowdown from the earlier brisk pace.[1] In response, and starting with Deng Xiaoping's famous "Southern Tour" in 1992, the Chinese authorities re-energized their structural and macroeconomic reform program focusing on the critical growth impediments imposed by large, inefficient, and loss-making state-owned enterprises, which put a drag on productivity of the entire economy. [While some industrial policy thinkers and planners have tried to pin China's success in micro measures such as special-trade zones or superior planning, this misses the far more critical importance of macro policy.]

China's Shift to an Investment- and Export-led Growth Model

The critical reforms pursued in China comprised opening up the economy to (private and foreign) competition, including via large-scale privatizations. These were key in tackling these low-productivity, rent-gobbling state-owned behemoths—even at the cost of large job losses. These structural reforms were flanked by the drive to maintain macroeconomic stability with low inflation. Together, this policy mix released resources to more productive purposes and set the stage for the impressive turn toward an investment- and export-led growth model and laid the foundation for the significant reacceleration of growth and consistent outperformance over India. Moreover, and perhaps somewhat unintuitively, consumers did better in China's investment- and export-led growth model than in India's consumption-led model as the time series of real consumption growth makes clear (Figure 2).

Figure 2: India's consumption-led growth model does not ensure better consumption growth—capacity limits tend to create inflation and balance of payments pressures.



Source of left and right graphs: World Bank as of December 31, 2018. Source of middle graph: International Monetary Fund as of May 2019.

Critical Reform Objectives for India: Increase Savings and Raise Productivity

We would argue that this history holds significant lessons for India. The take-away is not that China implemented perfect reforms. Much rather it focused on those, most necessary, policies to step up investment and exports, the model that underpinned a sharp and sustainable rise in economic performance. While the Indian government's focus—most recently enunciated in its 2020 budget—is also to move India to the same investment- and export-led growth model, the lesson for India must not and cannot be to follow the specific Chinese reforms in a "cookie-cutter" manner. Instead, the focus of Indian policy makers must be to identify the key impediments to higher growth and better resource allocation, and to redress the most important ones, notwithstanding the very likely strong political opposition from vested interests.

Without a doubt, the current global environment—marked by U.S.-China trade tensions, rising labor costs in China and a need to find alternative supply chains—is conducive to India's success in becoming the next big Asian export and manufacturing powerhouse. However,

[1] The slowdown reflected a number of factors, including the maturation of earlier reforms in the agriculture sector, and the clout gained by large state-owned enterprises after initial liberalization steps made them dominant market monopolists.

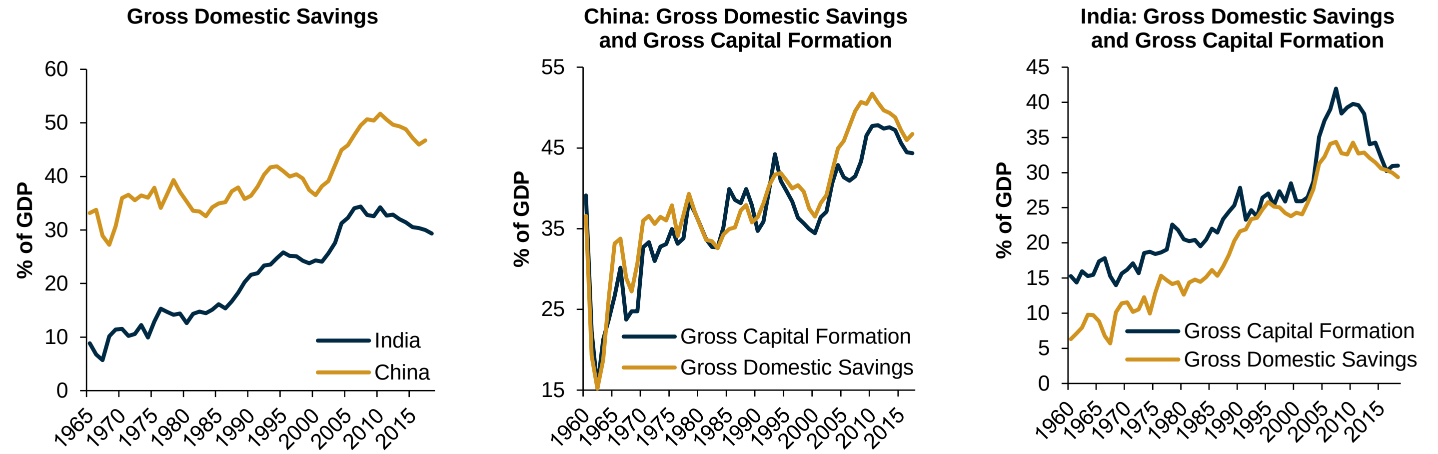
and just as in the case of China in the early 1990s, critical growth-stifling domestic growth obstacles remain to be tackled. Importantly, seemingly plausible industrial policy and economic planning schemes are unlikely to help. Much rather, the Chinese experience makes amply clear that sound macroeconomic policy and less state control are the way to go.

What then are the critical reform objectives for India to move toward an investment- and export-led growth model? At the very root lie two intermediate objectives. First, increase in the savings rate and second, raise productivity. We will touch on these critical dimensions in the following paragraphs.

Higher Savings—The Resource for Investment

India runs large current account deficits, which implies that higher domestic savings will need to underpin any increase in investment. Countries typically have to rely on a large pool of domestic savings in order to sustainably boost investment, rather than sharply widening current account deficits. Figure 3 shows that China's much higher and rising savings rate enabled a strong uptick in investment. Conversely, low savings constrained investment in India, especially recently. While many, including the Chinese authorities, consider recent investment rates in China to have overshot and resulted in capital misallocation, India's investment share considerably trails comparable economies and can be raised without triggering such concerns.

Figure 3: China's much higher savings ratio has underpinned its investment acceleration, while India's lower—and recently declining—savings ratio has crimped investment.

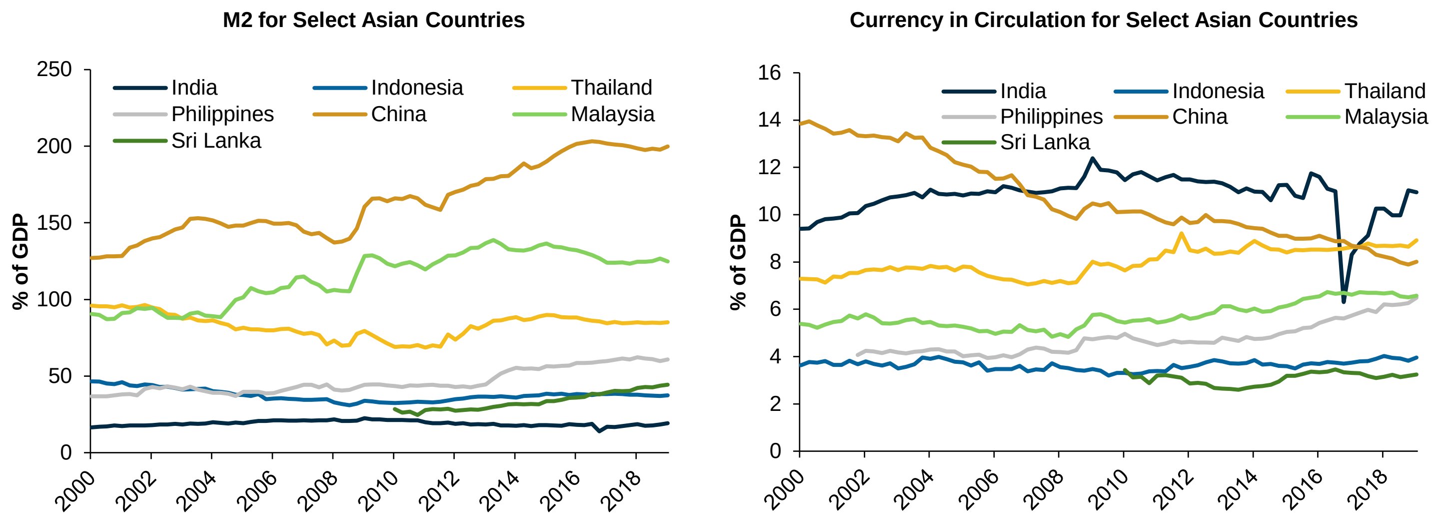


Source: World Bank. Left and right graphs as of December 31, 2018. Middle graph as of December 31, 2017.

However, raising savings is easier said than done. The FY20 budget's embrace of export- and investment orientation by definition implies reversing India's past consumption-led growth model and targeting a higher savings rate (savings is defined as the difference between income and consumption). While the objective is clear, the actual measures, though, are not, and have in the past even been contradictory. The critical element is fiscal consolidation, as the very large dissaving in the public sector (central and state governments as well as borrowing needs of parastatals and public enterprises) has tended to offset any private sector savings efforts.

Moreover, such high public sector borrowing also crimps financial savings and financial deepening, with a resultant negative feedback loop on public finances. Even India's comparatively low macroeconomic savings do not find themselves into *financial* savings—i.e., loanable funds that can be intermediated between savers and borrowers. Instead, a considerable share of Indians' savings are held outside the financial system in gold, real estate, or cash (Figure 4). Such low levels of financial savings typically result from high inflation—as the private sector seeks to protect its assets from the inflation tax. Indeed, India's inflation has been high and variable as the government has relied on the inflation tax in the past, making nonfinancial savings a prudent decision in many savers' minds. In addition, the de-monetization scheme likely also served to caution savers from trusting financial assets.

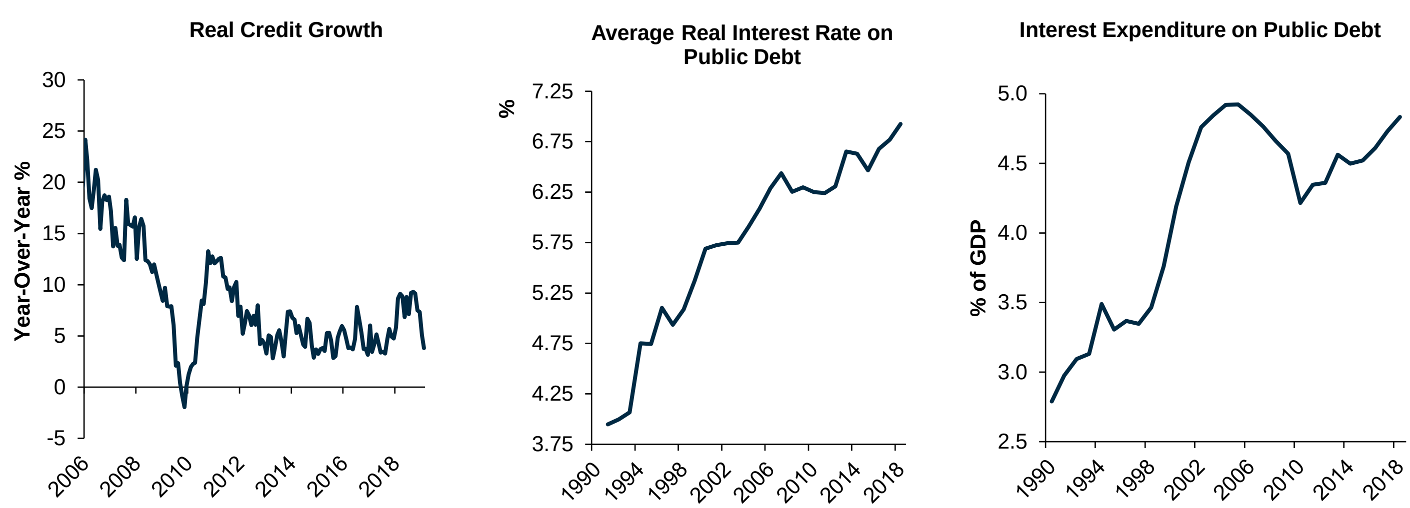
Figure 4: India exhibits very low financial savings even compared to South Asian peers, which has limited the extent to which the inflation tax (*seignorage*) can be collected.



Source: Government-released data from each country as of March 31, 2019.

Moreover, the bad news for India does not stop there. Efforts to bring down inflation have required a move toward positive real interest rates. In the context of still high and recently rising public borrowing requirements, this crowds out private-sector borrowers and also saddles the public sector with growing interest expenditures, which in turn add to the public sector borrowing needs (Figure 5). Savers can be forgiven in such an environment to be reluctant in bringing down inflation expectations, as they may fear that government may in the end once more rely on higher inflation in order to ease its financing constraints. The critical missing element for entwining this Gordian knot is thus once again a credible and structural fiscal consolidation plan based on real tax and/or expenditure measures.

Figure 5: Higher real interest rates in India have tamed inflation, but high fiscal financing needs have crowded out private investment and raised public debt pressures.



Source of left graph: Reserve Bank of India, International Monetary Fund as of April 2019. Source of middle and right graphs: International Monetary Fund, author's calculations as of December 31, 2018.

The policy lesson here is thus fairly clear and twofold: first, higher savings cannot be achieved without fiscal consolidation, and second, higher savings will likely have a positive knock-on effect on fiscal consolidation. This is a task that China was able to largely avoid during its successful growth spurt, as macroeconomic savings were high and the authorities kept inflation low and stable, except in periods of significant price liberalization. Against the background of the profound and repeated difficulties of various Indian governments in effecting more substantial fiscal consolidation, this is clearly a politically difficult endeavor, likely on the scale of tackling deep-seated SOE inefficiencies in China during the 1990s. Nevertheless, as discussed in the preceding paragraphs, fiscal consolidation is a *sine-qua-non* for a move toward a new growth model.

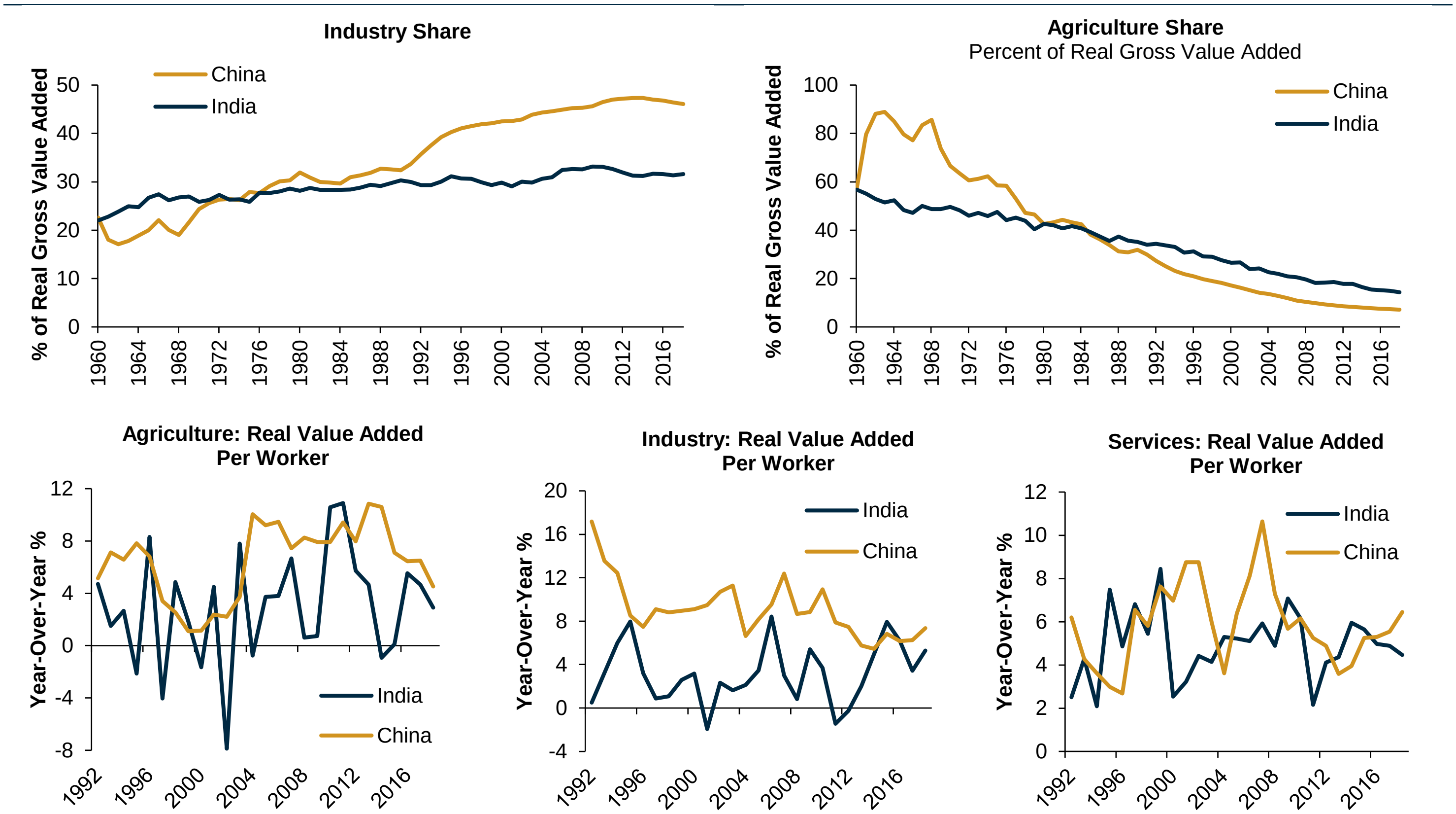
Fortunately, while progress on fiscal consolidation has been wanting so far, some critical tools are now in place that could catalyze future progress. Most importantly, the introduction of the countrywide GST offers potential significant revenue sources if it is simplified and loopholes are closed; similarly, the ongoing rationalization of subsidies could help trim spending. Meanwhile, stepped-up divestiture—especially if directed toward foreign investors—could provide some interim financing relief without crowding out private-sector projects and lower the stock of public debt; it will likely also have the side effect of better productivity and resource allocation, the second critical challenge, to which we now turn.

Higher Productivity—Making the Most of the Available Resources

Apart from generating larger domestic and financial savings, higher productivity is essential in order to make the most of any resources available. Macroeconomic productivity is the other key aspect where India has been lagging China. Two key channels have been at play (Figure 6):

1. India's manufacturing-sector growth has been considerably underperforming, dragging down macroeconomic productivity given that manufacturing traditionally tends to be the most productive sector. At the same time, the low-productivity agricultural sector has remained more important.
2. Even within the manufacturing sector, India's productivity has trailed. Moreover, China also managed to make its agricultural sector more productive, thereby facilitating the shift of workers from agriculture to manufacturing.

Figure 6: India's manufacturing sector has lagged considerably and so have sectoral productivity trends.



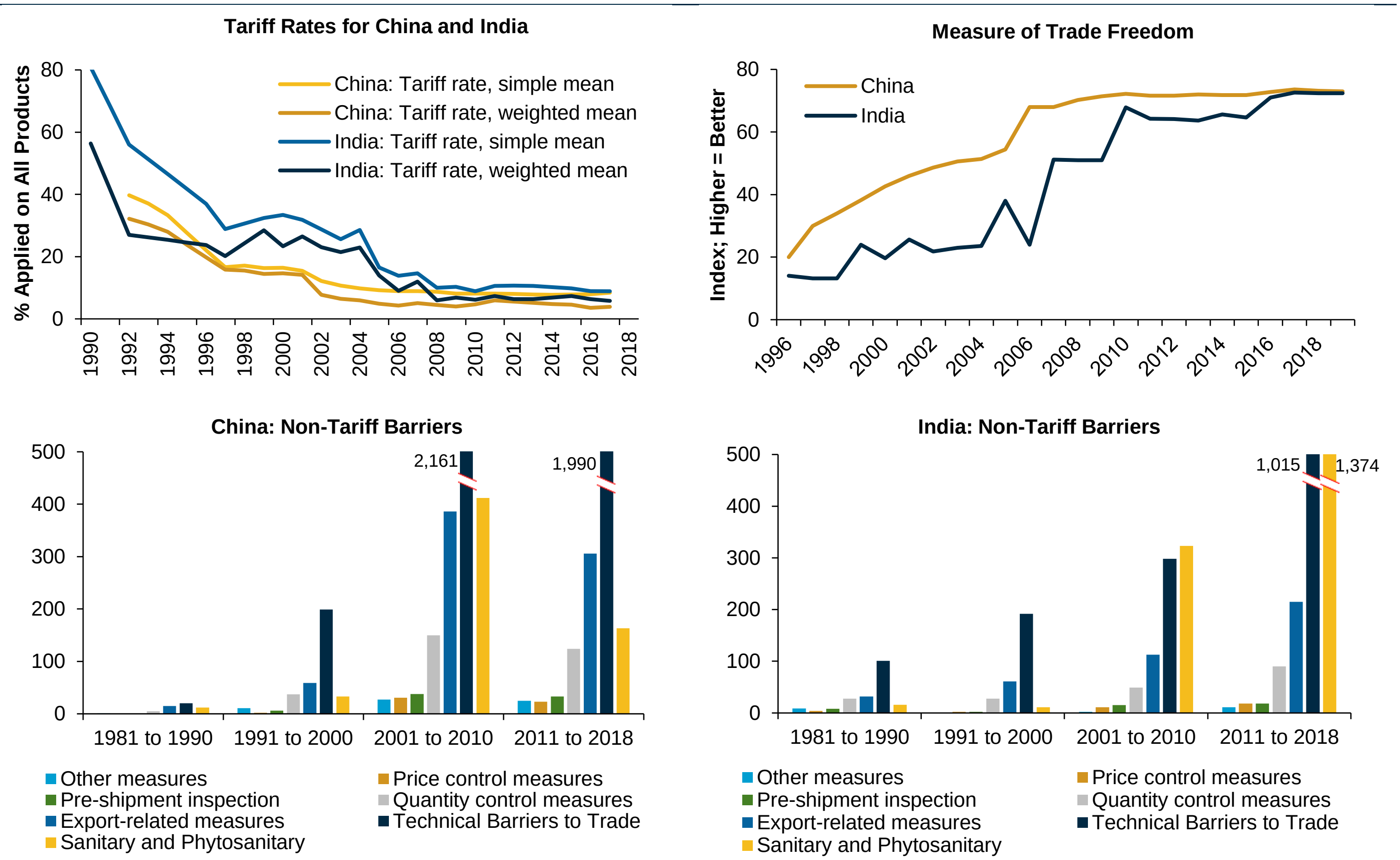
Source: World Bank as of December 31, 2018.

The substantially more closed Indian economy is likely to be a key explanation for these lower productivity levels. Productivity tends to rise if resources can be brought to their most productive resources. Efforts to steer scarce resources to alternative uses—whatever their political merits may be—tend to lower productivity. Moreover, even interventions that may have had considerable merit some time ago tend to create political constituencies and rents which are difficult to undo in future times. Indeed, China's 1990s reform drive is best understood as a large-scale frontal attack on domestic rent-seeking interests (in the state-owned enterprise sector) by unleashing both internal and external competition. India also has its share of vested rent-seeking interests which curtail greater economic efficiency—for example certain agricultural interests, industries sheltered from external trade competition, and domestic entrepreneurs who enjoy captive financing at better terms than existing or potential competitors. As Figure 6 shows, taking these vested interests on offers large rewards in economic growth.

In contrast to the somewhat wanting fiscal efforts, the last four years have seen some welcome government initiatives to increase *domestic* competition and efficiency. First, the introduction of the Goods and Services Tax created an internal market with much greater efficiency. Second, the introduction of the new insolvency regime offers a legal mechanism to help scarce financial resources be better allocated, while the general improvement of the business environment—highlighted by India's ascent in the World Bank's Doing Business Tables—has facilitated entry of new competitors, thereby making markets more contestable and less monopolistic. Finally, Prime Minister Modi has continued to emphasize the need for further opening and attracting foreign direct investment.

Unfortunately, *external* trade liberalization has not kept the same pace (Figure 7). Indian objections prevented the conclusion of the Doha Round of World Trade Organization negotiations. Moreover, while tariffs have been cut significantly, they remain comparatively elevated and non-tariff barriers have continued to grow. One effect of these policies has been to raise the ire of the U.S. authorities who have revoked some of India's preferential trading terms. Arguably even more important is the domestic anti-export bias that such trade restrictions imply as exporting sectors tend to be the most productive, being as they are exposed to strong global competitive pressures. Without them India deprives itself of an important growth engine that not only China, but many other emerging market countries, have successfully used.

Figure 7: India has been slower to reduce trade protection. While tariff rates have come down in line with international practice, non-tariff trade barriers remain pervasive and may have recently picked up.



Source of top left graph: World Bank, December 31, 2017. Source of top right graph: Heritage Foundation, March 31, 2019. Source of bottom graphs: United Nations, December 31, 2018.

Conclusion: Essential Benefits of Fiscal Consolidation, Trade Liberalization, and Market Opening

We have outlined why India may be well placed to replicate China's historic rise over the last three decades. The chance of success, however, rests on India being able to drastically increase domestic savings and economy-wide productivity. The current situation—with China losing cost competitiveness and being in the crosshairs of a trade conflict—offers an opening for India, while the Indian government has enunciated a comprehensive vision for the required shift to an investment- and export-led growth model.

Against this backdrop, It is now important for India to focus on the essential required reforms, namely true and structural fiscal consolidation, as well as market opening and tackling domestic rent-seeking sectors. While the progress on the former has been disappointing so far—no doubt reflecting very large political obstacles—there has been important progress on the latter. Going forward, overcoming political difficulties, initiating fiscal consolidation in earnest, while progressing with greater market opening—including importantly, to foreign competition—offer great rewards. Indeed, China's experience in the 1990s illustrates the rewards if political difficulties are overcome.