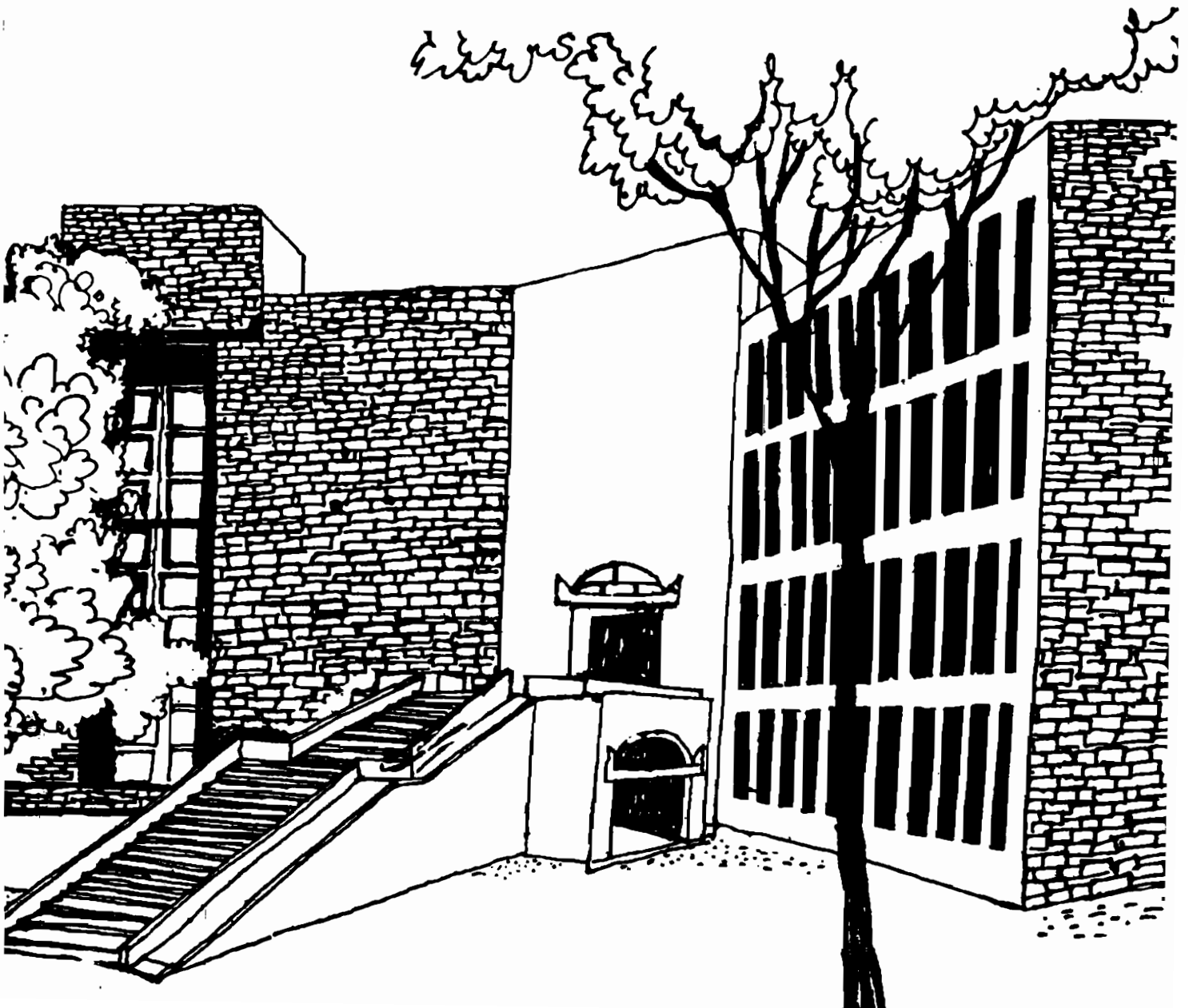




# Working Paper



## **Why are we Junking this Engine of Growth?**

Sebastian Morris

Working Paper No. 1370  
April, 1997

The main objective of the working paper series of the IIMA is to help faculty members to test out their research findings at the pre publication stage

**INDIAN INSTITUTE OF MANAGEMENT**  
AHMEDABAD 380015  
INDIA

**PURCHASED**

**APPROVAL**

**GRATIS/EXCHANGE**

**PRICE**

**ACC NO.**

**VIKRAM SARABHAI LIBRARY**

**I. I. M., AHMEDABAD**

## Why are we Junking this Engine of Growth?

### *Abstract*

*Over the last year and a half, the real value of the rupee has been going up. Neither the government in its budget or otherwise, nor the RBI, seems to be concerned about the deleterious effects of the same on export growth. Both government and the RBI plan to strive for capital account convertibility, even at the cost of export growth and growth in general. The argument that capital flight takes place anyway, so that capital convertibility should not affect it, is fallacious. Growth is the key to surplus retention, and the recognition of significant capital flight from India would mean that policies would have to be directed not only to attracting capital from abroad (FDI, portfolio investments) but also for surplus retention. Only high growth can ensure that the incoming capital does not merely lead to displacement of domestic surpluses (capital flight) in investment, but adds to domestic savings to raise the overall level of savings and investment. Expansion of exports especially of those that arise in small firms, is a near perfect answer to raising the overall growth rate. A significant depreciation of the currency, besides enhanced credit through a major reform of the banking sector would be necessary. On structural considerations, there is no getting away from exports' inevitable role as the engine for India's industrial transformation.*

The promise of fast growth and globalisation ushered in by Manmohan Singh's first budget has, to most observers, been kept up by Chidambaram's. The budget, despite the uncertainties regarding its adoption, has been lauded by many. Yet, a more careful examination, especially with regard to the external sector, reveals that the budget and policy do not take advantage of the vast opportunities for fast growth that the present economic situation, both within and without, offers.

Over the last year and a half, the real value of the rupee has been going up. Since the presentation of the budget in Parliament, even the nominal value of the rupee has been increasing, and neither the government, in its budget or otherwise, nor the RBI, seems to be concerned about the deleterious effects of the same on export growth. One of the important changes brought about by the liberalisation (besides delicensing and large inflows of FDI) has been the increasing openness of the economy. The enhanced growth in excess of 6.4% in the nineties can ultimately be traced to the increasing openness of the economy - specifically to high rates of export growth. The liberalisation, and more specifically the reduction in import tariffs and the sharp depreciation of the rupee in the initial years of the liberalisation, served to maintain the rise in the openness of the economy. Since the mid-seventies, openness had been rising but was showing a tendency to stagnate by the end of the eighties. It removed the bias against exports, which had long been a

2

standard feature of the Indian economy: from the fifties almost up to the end of the eighties. For the first time the relative openness of the economy reached the levels of the early fifties, and the prospects for the (re) globalisation of the economy seemed real. Alas, the last year and half may have arrested the growing openness of the economy. Exports, which had been growing at close to 19% per annum in dollar terms, grew less than 6% in 1996-97. Export growth may fall further unless the value of the rupee is corrected. Indeed, a sharp depreciation to restore the relative profitability of exports to the levels in 1991-92, and more is necessary.

But Chidambaram's pronouncements and RBI's monetary policies are not conducive to keeping the rupee value down. Both government and the RBI plan to strive for capital account convertibility, even at the cost of export growth. Capital account convertibility as a long term goal (once the economy has completed its industrial transformation) is valid. But now, when the savings and investment rate are still less than 26% of GDP, it could prove to be a one-way ticket to a dysfunctional and irreversible maturity of the economy, that would exclude the bulk of its people. The real sector and policies for its development are far more important than policies that serve interest and rent earners. It is important to remember that only by the late sixties and early seventies were the European economies able to achieve capital account convertibility. And none of the East Asian economies other than Hongkong and Singapore (and only now Taiwan) have anything like capital account convertibility. Latin American countries with capital account convertibility for long (some of them even in the pre war period) have not been able to retain their economic surpluses domestically, leading to capital flight of a very high order, and to cycles of boom and bust. None of them have become advanced countries, and late starters like Japan and Korea have overtaken them. Freedom for corporates to make foreign direct investments abroad, to augment the export effort (investments in retailing and distribution), investments abroad to secure raw materials, can exist without general capital account convertibility. Such freedom exists for corporates today, and the difficulties that remain are largely due to procedural and bureaucratic modes of decision making, which would have to go.

Capital flight from India has been quite large relative to the debt incurred by the economy. In some estimates it may have been (1978-1984), close to about 40% of incremental debt over the same period [Duwendag, 1989]. Many other studies would show that it was sufficiently high, of the order of a percent or so of GDP at least, unlike in the case of Korea, Taiwan or Japan in

the immediate post war period. With capital account convertibility the reverse flow of resources can only increase. The argument that capital flight takes place anyway, so that capital convertibility should not affect it, is fallacious. It ignores the vast potential for legal capital transfer for real estate purchases and for consumption abroad, which remains muted under the present restrictions. Moreover it comes from a (thin) super rich elite, in an economy with highly unequal distribution, who are joined in by a large number of successful rent seekers (beneficiaries of payoffs, kickbacks, and monopoly capitalists). Other productive capitalists, who mistakenly believe that capital account convertibility is the solution to the bureaucratic hassles they face with regard to capital export for productive activity abroad, have unfortunately lent support to this demand. Restrictions on capital transfer today serve to retain within (for investment), at least in part, the vast amounts of rents that are presently generated.

Capital flight from India is largely an economic phenomenon (unlike in Latin America where it is social and political). It has been high when growth and investments were low in relation to the surpluses (including rents) being generated. Despite the liberalisation and the modicum of competition that it has brought about among corporates, margin (on sales) remains high. The fall in margins that the fast growing economies (Japan, Korea, Taiwan, and Thailand (now)) showed, even as the return on capital employed remained high, is, not as yet, a major phenomenon in India. Most industries except a few (textiles, two-wheelers, cement, some electronic goods, with large markets), have been able to maintain high margins. The surpluses the economy generates today remain very large, although the forms may have changed; from rents on licences and favourable govt. dispensation to rents on privatisation and contracts, from monopoly profits to competitive profits and rents arising out of regulatory failures. Growth is the key to surplus retention, and the recognition of significant capital flight from India would mean that policies would have to be directed not only to attracting capital from abroad (FDI, portfolio investments) but also for surplus retention. Only high growth can ensure that the incoming capital does not merely lead to displacement of domestic surpluses (capital flight) in investment, but adds to domestic savings to raise the overall level of savings and investment.

Today, the rate of growth at which India would be able to absorb external capital without losing domestic surpluses in capital flight would be well in excess of 9%. This may seem too optimistic and possibly fanciful to those who had their intellectual development in the "Hindu"

period (1965-1979) of Indian economic development, when growth averaged less than 4.5%.

The facts (see [Morris, 1997] for the details) do indicate that this growth rate of 9% is achievable:

For the last six years if not more the economy has been increasing its growth rate even as inflation has been coming down. This negative association of inflation with growth would in an extended keynesian frame work imply that the economy has been working at well below the maximum potential growth rate it can achieve. Analysis for an earlier period, shows that even in the eighties [Dholakia, 1987], the usual expected trade-off between inflation and growth was not there. In other words the economy is clearly demand constrained.

Being demand constrained, autonomous and exogenous expenditures have driven the system, so that an expenditure based model best tracks national income.

Exports, and agriculture have been the principal causal factors in growth. The statistical basis in the form of McClave-Hsiao Tests confirm the same. When exports grew at 19%, investments at less than 9%, and agriculture at 3.5%, output growth was at 7%. If exports can continue to grow at 18-20%, and the investment growth rate stepped up to 15 to 20% per annum, rates around 9% are eminently possible. If agricultural growth can be raised to even 4% on a sustained basis, 9% is painlessly assured, since the increased demand for wage goods (including food that a 9% growth rate would entail, can be taken care of by domestic agricultural production.

Investments as a proportion of GDP would then have to rise by 1.5% a year to reach levels close to 33-35% from the present 27% (savings 26%). Nearly all of these increased investments, would be covered by rise in domestic savings, since the marginal propensity to save is close to 36%. In other words at a marginal propensity to save of around 36%, investments are the key to raise the domestic savings rate, rather than classical savings policies like higher rates on deposits etc. The savings constraint has been overemphasised.

Much of the expenditure increases that drives growth would have to be from exports (and

undervalued unlike, that of China (over 90% undervalued), Korea, Indonesia, Malaysia, and Thailand (about 30 to 70% undervaluation). The scope to enhance the incentives for tradeables, especially export goods production is huge via a disequilibrium exchange rate strategy like that followed by nearly all the dynamic East Asian economies and China. Export growth at 20% in dollar terms for India for the next 10 years is possible with the right exchange rate policy. (Ultimately monetary policy and fiscal policy in a regime of dirty floating exchange rates). The tax cut for corporates and the tax on dividend, since they have the tendency to raise investments, are in the right direction. But growth in this fashion can only lead to pressure on the balance of payments, as the bias against exports continues without correction. It would therefore not be sustainable. In other words the incentives for investment should have been accompanied by major expenditure switching in favour of tradeables.

Higher growth rate can would in fact reduce the incremental capital output ratio (ICOR) rather than increase it, especially if it can (and only so can it) come from export growth. The response of the Indian economy to the depreciation in Manmohan Singh's early budgets have been excellent and possibly one of the best that any country has had, especially when we recognise that this was at a time when the Soviet market had collapsed. Much of the dynamism (and this is structurally ordained, given India's poor land man ratio and natural resource endowment) has come from the manufacturing sector. Especially those using semi and unskilled (and even skilled) labour with high intensity. The small scale industry has been most important in this regard, since it is the sector that use abundant factors (skills and labour) intensively. An export led growth strategy would mean declining ICORs since the small firms would need little capital to vastly expand output, certainly so in the medium term. After a few years, infrastructural constraints would not doubt emerge. Small and medium firms have been the source of probably as much as 70-80% of the export expansion in manufactured goods in the nineties. Thus growth would, as it should, be self financing.

In a regime of floating exchanging rates with perfect capital mobility, we know from simple theory (Mundell Fleming Model) that for an economy with unutilised resources it is possible to, by expansionary money supply, grow (without inflation) via a depreciation of the currency. Assuming that the economy has the ability to rapidly switch to tradeables production. Japan, in the fifties and sixties, Korea until very recently, China, Indonesia, Malaysia and Thailand



6

today are clear examples of economies which have been able to grow, at the expense of the rest of the world through highly undervalued exchange rates. Germany after unification was able to absorb the surplus resources (skills and manpower) of former East Germany into productive use via such expansionary policies. Developed economies do not generally use this strategy because they have little idle resources waiting to be put to use. Moreover in many of them the rise of middle and working classes' financial assets places a premium on low inflation so that there is a great political aversion to even moderate inflation. India is one of the most diversified economies in the world, and among the third world countries the most, and has a surfeit of skills and a demonstrated ability to respond to price and market incentives to produce for exports. There is little reason to not use disequilibrium exchange rates to enhance exports, hence expenditures, and so growth.

Export expansion, is a virtuous circle because of the many positive externalities (scale economies, quality and feature improvements, faster technology absorption) in export, besides of course the automatic market discipline it imposes upon firms.

Late industrialisation has meant faster growth. This is the Gerschenkron [1966] thesis for which there are almost no exceptions. Today, for countries unambiguously on their industrial transformation, and who started in the sixties or the seventies (China, Thailand and Vietnam), the norm seems to be rates in excess of 8%. India which spent a generation in import substitution (which biased against exports), has over this long and costly process developed the skills and competencies for a great expansion of the manufacturing sector. The time is ripe to intensify growth, reaping the advantages created by past policies. The thesis that export promotion and import substitution cannot coexist at the same time is proven wrong by the East Asian industrialisations. Moreover, such a thesis does not arise in a more realistic multi commodity model of trade, being only a special feature of the two-commodity model.

Coming back to the budget and to macro economic policy the following would need the urgent attention of policy makers:

The appreciation of the rupee has to be reversed. Otherwise exports would come crashing and growth would not be sustainable. Debt servicing which is growing at rates in excess of 16%

alone would call for exports to grow at rates higher. As India grows, the need for imports of natural resources: fertilisers, food, energy, vegetable oils, non ferrous materials would rise sharply at rates higher than the overall growth rate of the economy. This would make export expansion at rates close to 20% necessary for the unambiguous transformation of the economy.

In a regime of dirty floatation, expansionary monetary policy can do the job if investments can pick up. The recent slack season credit policy announced by the RBI is therefore in the right direction. But the investment increases have to be of a much higher order, to allow for growth sufficiently high to maintain the gap in the balance on current account to allow for capital inflow (without capital flight). Fiscal policy, such as massive expansion of the power sector even via a monetisation is justified. Power is possibly the only real short term supply side constraint.

The monetarist blinkers have continued to restrain demand because the fear of inflation has loomed large. As a result conservative (as regards the achievable growth rate) policies have been the norm. and the present budget is no exception. An incomes policy that reduces consumption expenditures especially of imported consumption goods, via forced saving for instance, or delayed income encashment for the organised sector is always possible, in case inflation rears its head. It is time the RBI gave up its rule of 15% for monetary expansion (7% growth, 7% inflation and 1% for deepening of the cash economy) and instead go on a more ambitious 19%. Credit expansion in real terms has been negative last year. Continued efforts to sterilise the inflows of capital can only be counter productive.

Credit to small firms, and especially export related (packaging, and post and pre-shipment), has been tardy. This has been the most important immediate reason for the fall in export growth. A permanent solution to the problem of credit supply to the small firms, and to the emergence of efficient credit markets, would mean the complete revamping of the oligopolistic banking system. Incentives for accounts development and for performance would have to be integral to the management of banks. Directed credit has been the biggest failure of govt's credit policy in recent times. The banks in the liberalised environment have conveniently used their new found freedom to violate RBI guidelines on credit direction. They have only reluctantly lent to the small industry, despite little objective basis for such behaviour. Incentives for banks (lower tax rates, lower SLRs) for lending to the sectors of priority, or those with high positive externalities and suffer

The growth of the small firm sector becomes vital for several reasons. Not only has this sector the best potential to greatly expand exports, but it can do so with the addition of very little capital. Additionally, this is the only sector in which employment grew in excess of 4.5% per annum over the eighties. The organised private sector is not going to be an important source of employment generation. And as the pressures on the public sector to become commercially oriented have increased and they are being subject to hardening budgets, the growth of employment has been negative. Sustainability of growth demands employment generation at rates significantly higher than the population. Many small-firm and export-oriented sectors like gems and jewellery, handloom and powerloom cloth, garments, handicrafts, hand-tools, etc. employ among the poorest sections of the population so that their expansion would also reduce poverty. Thus the export oriented expansion of the small firm sector is the one leverage point for change, and the key is credit expansion, and currency depreciation.

### References

- Alagh, Yoginder; R. J. Mody and Rohit Desai (eds.), "Stability and Development: Essays in Honour of Dr. D.T. Lakdawala", Sardar Patel Institute of Social and Economic Research, Ahmedabad, Har-Anand Publications.
- Dholakia, Ravindra (1993), "Supply Shocks and Strategy for Recovery and Stabilisation in India", in Yoginder Alagh et al (eds.).
- Economic Survey, various issues, Govt. of India, Ministry of Finance, Economic Division.
- Gerschenkron, Alexander (1966), "*Economic Backwardness in Historical Perspective*", Cambridge, Mass., Harvard Univ. Press.
- Duwendag, Dieter (1989), "Capital Flight from Developing Countries", *Economics*, Vol.38, pp.26-29.
- Morris, Sebastian (1997), "Why not Push for 9% Growth", Indian Institute of Management, Working Paper No.1364, April, mimeo.

Table 1: Certain Aspects of the Economy and the Central Budget

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
1 Gross domestic product at factor cost (constant 1980-81 prices)	201.45	212.25 (5.360)	213.98 (0.82)	225.27 (5.27)	238.86 (6.04)	256.10 (7.21)	274.21 (7.07)	292.90 (6.82)
2 Index of industrial production (1980-81=100)	196.40	212.60 (8.25)	213.90 (0.61)	218.90 (2.34)	232.00 (5.98)	253.70 (9.35)	283.30 (11.67)	307.95 (8.70)
3 Index of agricultural production 1981-82=100)	143.00	148.40 (3.78)	145.50 (-1.95)	151.50 (4.12)	157.30 (3.83)	165.00 (4.90)	164.30 (-0.42)	170.38 (3.70)
4 Openness ratio	0.15	0.16 (2.86)	0.17 (4.86)	0.19 (11.64)	0.20 (5.17)	0.20 (3.05)	0.23 (15.00)	0.22 (-6.94)
5 Exports (US\$)	16.61	18.14 (9.22)	17.87 (-1.53)	18.54 (3.76)	22.24 (19.97)	26.33 (18.40)	31.80 (20.76)	34.34 (8.00)
6 Imports (US\$)	21.22	24.07 (13.45)	19.41 (-19.37)	21.82 (12.42)	23.31 (6.80)	28.65 (22.95)	36.68 (28.00)	38.29 (4.40)
7 Total employment in organised public and pvt. sector (lakh persons as on March 31)	263.53	267.33 (1.44)	270.56 (1.21)	271.77 (0.45)	273.75 (0.73)	275.25 (0.55)		
8 Nominal effective exchange rate (5 country index) (1985=100)	56.00	42.15 (-24.73)	38.74 (-8.09)	31.84 (-17.81)	29.59 (-7.07)	28.51 (-3.65)	26.13 (-8.35)	
9 Real effective exchange rate (5 country index) (1985=100)	73.00	61.65 (-15.55)	58.56 (-5.01)	52.89 (-9.68)	52.82 (-0.13)	55.73 (5.51)	53.55 (-3.91)	
10 Unit value index of exports (1978-79=100)	276.60	292.50 (5.75)	369.50 (26.32)	421.50 (14.07)	474.10 (12.48)	494.60 (4.32)	484.20 (-2.10)	
11 Net terms of trade (1978-79=100)	121.10	109.30 (-9.74)	119.50 (9.33)	127.30 (6.53)	144.90 (13.83)	152.40 (5.18)	137.90 (-9.51)	
12 Income terms of trade (1978-79=100)	211.80	212.20 (0.19)	249.30 (17.48)	283.80 (13.84)	373.10 (31.47)	446.00 (19.54)	530.00 (18.83)	

13	Implicit deflator for GDP at factor cost	202.86	225.12 (10.97)	258.32 (14.75)	280.01 (8.40)	306.40 (9.43)	335.16 (9.39)	359.50 (7.26)	389.10 (8.23)
14	M1 (money supply with the public as on March 31)	42.59	44.32 (4.05)	46.71 (5.40)	46.80 (0.20)	53.07 (13.39)	57.36 (8.08)	59.52 (3.76)	58.60 (-1.55)
15	M3 (Aggregate monetary resources as on March 31)	117.91	123.32 (4.59)	126.96 (2.95)	135.31 (6.58)	147.58 (9.07)	158.56 (7.44)	167.98 (5.94)	175.73 (4.61)
16	Bank credit to the commercial sector (as on March 31)	77.28	79.40 (2.74)	76.38 (-3.80)	81.25 (6.37)	79.85 (-1.72)	87.34 (9.38)	95.75 (9.63)	92.64 (-3.25)
17	RBI's net credit to the government (as on March 31)	36.32	39.47 (8.66)	36.39 (-7.79)	35.16 (-3.39)	32.41 (-7.82)	30.28 (-6.58)	33.70 (11.30)	33.32 (-1.13)
18	Other banks' credit to government as on March 31	21.89	23.33 (6.57)	24.99 (7.12)	28.14 (12.58)	34.85 (23.87)	36.08 (3.53)	37.31 (3.39)	42.93 (15.06)
19	Net foreign exchange assets of the banking sector as on March 31	3.36	4.70 (39.85)	8.22 (74.82)	8.91 (8.45)	17.18 (92.74)	23.21 (35.12)	21.46 (-7.52)	23.73 (10.55)
20	Total expn. of central govt. final outlays on consumption expenditure	10.25	9.93 (-3.06)	9.47 (-4.64)	9.59 (1.30)	10.38 (8.22)	10.41 (0.22)	11.67 (12.15)	12.36 (5.93)
21	Total expn. of central govt. final outlays on gross capital formation	4.01	3.82 (-4.74)	3.58 (-6.20)	4.24 (18.33)	4.17 (-1.77)	4.27 (2.61)	5.03 (17.58)	4.64 (-7.64)

NB: Items (14) to (21) are values deflated by the implicit deflator; All rupee values are in thousand crs., Dollar values in millions; Figures in brackets are percent change over previous year.

