Indian Demographics & Governance ECONOVIEW

by *Sundar Sankaran*[1]

BACKGROUND

The spotlight is on the Indian economy with weak GDP growth at 5.3% in 2011-12 Q4. This is the worst quarterly growth in nine years. With inflation at 10.36% (based on Consumer Price Index) for the year upto April 2012, fears of stagflation are being raised.

The finance ministry and the Reserve Bank of India (RBI, India's central bank) are blaming each other, with Eurozone crisis also being mentioned as a contributory factor. This column takes an objective look at the reasons for the economic crisis.

ECONOVIEW (JUNE 11, 2012)

A graphic plotting of the cause-effect relationships and inter-play of diverse factors, the Economaze, is shown in the annexure. The big factors scripting India's economic story are its demographics and governance.

Demographics

Even historical economic data can change in India. What will not change for a few decades is the demographic factor. A growing young population with strong aspirations is the fulcrum of economic growth in India. This boosts consumption of goods and services, including education. Whether the demographic structure contributes to a dividend or a divider will depend on governance.

Governance

The central government has shown determination and zeal in a few areas of social justice (or perceived social justice), such as, Mahatma Gandhi National Rural Employment Guarantee Scheme (NREGS), policy on land acquisition, continuation of inefficient subsidy schemes and reservation in education for the disadvantaged. Each of these politically lucrative areas has contributed to greater demand in the economy.

In a country where social security structures are otherwise weak, some of these measures are important. However, when such demand-accretive measures are not matched by supply-accretive measures, inflation is inevitable. Basic economics, Mr. PM.

Rising demand + Supply not keeping pace = Inflation.

An unbelievably myopic state leader (MSL) who has been allowed to exercise veto powers on any sensible economic policy has put the brakes on the central government. An active judiciary and mercurial Central Bureau of Investigation (CBI) have contributed to policy paralysis at the departmental level too. Power, telecom, other infrastructure, mining, banking, insurance, pension, special economic zone (SEZ) and reform in value added tax (VAT) are some areas that have borne the brunt of the sledge hammer. The resulting infrastructure bottlenecks and supply constraints are a significant factor pulling down economic growth.

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Infrastructure bottleneck + Supply constraints = Stagnation in economic growth

Stagnation + Inflation = Staglation fears

When economic activity is disrupted, government revenues too are affected. The wife can keep spending, only if the husband keeps earning. Else, the situation is ripe for disaster.

Higher social expenditure + Poor revenue growth = Mounting fiscal deficit

A government can prolong income-expenditure mismatches a bit longer than a family, because of its ability to print currency or raise taxes. Thank god for the MSL. Poor (and rich) residents of the country cannot be taxed more. Result: Go after the foreigners. Anyway, the MSL does not like them!

Therefore, even as the government was grappling with deep-rooted economic and political issues, it opted for a new challenge. It decided to take on international investors through some draconian retrospective taxation measures. These were partly modified subsequently. But the damage was done.

Economic Concerns + Tax Concerns = Poor Climate for Investors

Poor Foreign Institutional Investment (FII) and Foreign Direct Investment (FDI) climate are bound to hit investments from abroad. When existing investors, too, seek to withdraw their money, foreign currency reserves take a hit.

Meanwhile, remember the young population with aspiration? They wanted to spend globally on necessities, luxuries and education. Further, concerned over the state of affairs, they chose to switch their wealth to gold. Even if gold lies buried in the huge land mass of the country, mining policy and green laws will not let it come to the surface, officially. So the only avenue was to import gold.

Higher imports for consumption + Higher international expenditure by Indians + Higher gold imports = Higher trade deficit

If on the one hand, foreign currency reserves are whittled by international investors, and on the other hand residents contribute to a spiralling trade deficit, the local currency (rupee) had to face pressure.

High trade deficit + Poor investment flows = Weak rupee.

When the rupee gets weak, and the country is dependent on imports of oil, the price of oil has to increase in the country. You either let the price of oil increase (leading to cost-push inflation); or subsidise the local consumption (leading to fiscal deficit and demand-pull inflation). Hobson’s choice – or shall we say, choice of MSL?

In the meanwhile, the RBI, which is responsible for inflation control, was twitching its fingers. It needed to do something about all this inflation that was being unleashed on the economy. It took the only step that any monetary authority anywhere in the world will take in the situation viz. adopt a tight monetary policy.

Poor investment climate in any case made it uninteresting to invest. Higher cost of funds made it difficult for even the brave to invest. This has further aggravated the supply constraints and stagnation fears in the economy.

Companies that had already gone for debt-funded projects faced a double whammy of poor economic numbers and rising cost of debt. Banks are left brooding over looming non-performing assets (NPAs).

The Eurozone problems have little to do with the problems in India, which are largely self-inflicted. The tight monetary policy of the central bank appears to have been forced on to the country, by the omissions and commissions of the centre. It is up to the central government to buck up and extricate the country from the problem it faces.

What next?

Stagflation is doubtful. Indian demographics offer some insurance against economic stagnation. Near-term inflation depends on the monsoon. A good monsoon can keep food prices under check and ease inflationary pressures in the system.

The MSL is expecting freebies from the central government, so that more can be doled out to people of the state. The centre can buy temporary peace by giving away the freebies. But it risks similar demands from other states. This will worsen its fiscal position.

On the other hand, it can jetisson the MSL, who has the benefit of a heads I win, tails you lose situation. Denial of freebies can become a convenient excuse for justifying non-performance of the state despite MSL winning a landslide mandate from the people. A few more elections can be won on the plank of this “injustice” or “disrespect”. With freebies, MSL will have resources for some dole-based election victories.

If it shows the MSL the door, then the centre, during its remaining two years in power, will be at the mercy of other state leaders, who will flex their muscles, but are less myopic in approach.

No one wants a general election. If polls were to happen in the near future, neither the incumbent Congress, nor the principal national opposition, Bharatiya Janata Party (BJP) is likely to manage more seats in Parliament. Ideological differences come in the way of the two major parties fighting the next round of elections together.

A rag-tag of splintered parties grouping together as a third front or fourth front is likely to create more disarray in the economy and the country. This is a significant political risk that calls for caution. Hopefully, the similarity to Greece will be limited to frequent elections and unstable political groupings occupying positions of power.

If, during any brief window of unstable peace, the centre is able to pursue a progressive agenda and push through some much needed measures to lift the supply constraints, then the demographics will take care of the rest to keep the country growing at a handsome rate. This is the best-case scenario, where the country reaps the demographic dividend.

In the meanwhile, a social time bomb is ticking away. The demographics can become a divider, if the youth do not go for sensible education or find jobs. The education sector is facing the brunt of government activism. Despite special levies yielding significant revenues, the government does not seem to have any credible plan for serious capacity creation in education; worse, it may scare away private investment too. Poor education is a lead indicater of potential social unrest; lack of jobs on account of lower investments will compound the problem.

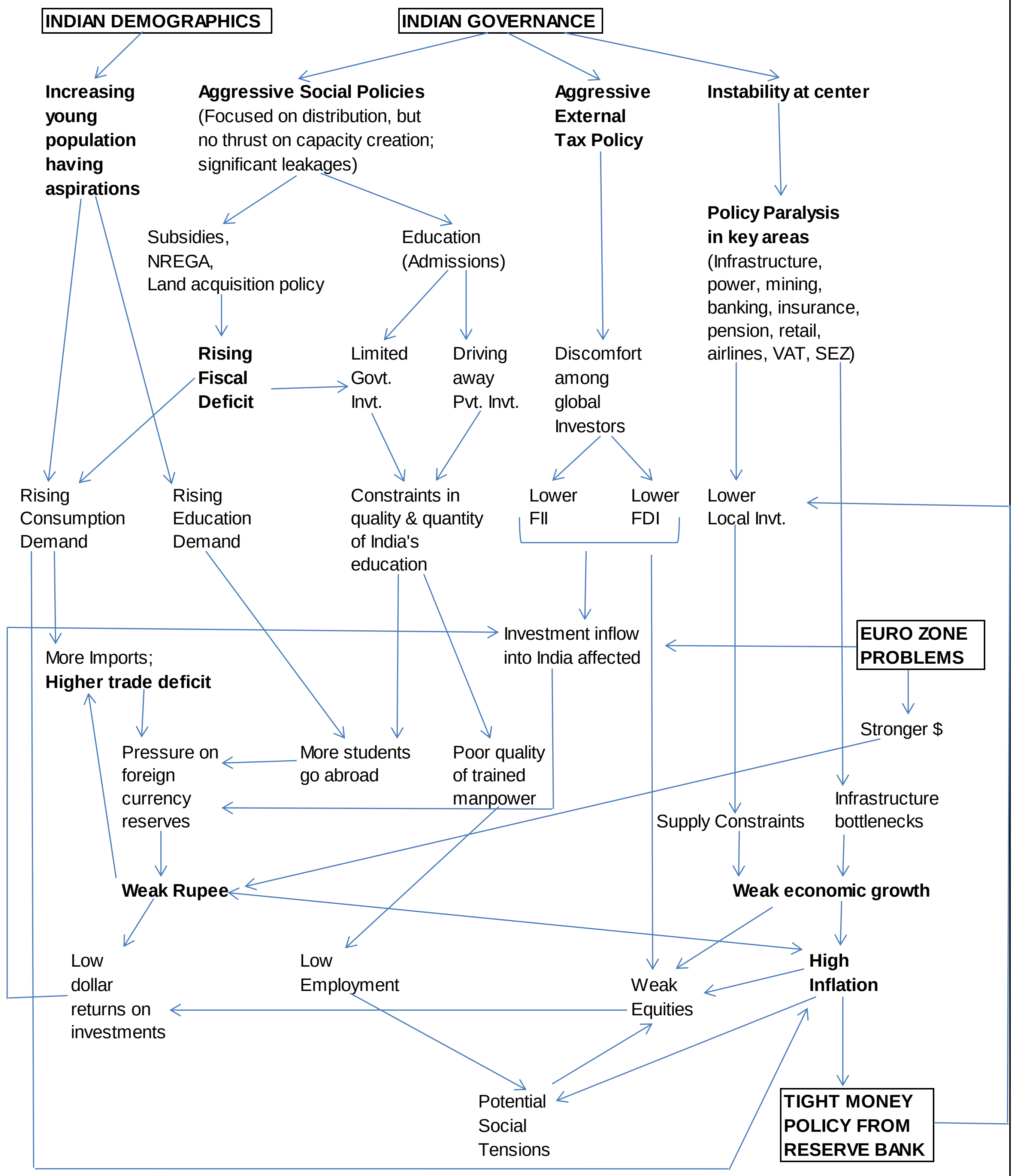
A silver-lining is the progress in mapping residents of the country, as part of the Unique Identification (UID) project. Despite hostility from powerful ministers pursuing petty agendas, and vested interests that want distribution inefficiencies to continue, UID has mapped more than a quarter of India’s vast population. Soon, the country will have a mechanism for direct transfer of benefits to the intended beneficiaries, bypassing intermediaries and limiting the leakages. Better targeted social justice will, in the long run, make governance more efficient.

Investors need to be prepared for turbulence in the political space as well as market space. RBI has made the first move in cutting interest rates. Though the scope for significant reduction is less, some easing in cost of funds can be expected. This should help debt investors.

Breaking news. S&P expects India to be the first BRIC to go below investment grade. I would have expected Russia to get that status. Having seen India rated below Eurozone countries that were near default, one wonders how well equipped rating models are in handling diversified economies like India having low external interfaces.

ECONOVIEW

June 11, 2012



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