India's Galloping Economy

– Factors Behind Boom & What Lies Ahead –

By Uchikawa Shuji

The Indian economy expanded for four straight years by 7% to 9% in fiscal 2003-06, attracting worldwide attention as the biggest emerging market after China. Until 1990, India had pushed forward with industrialization policies aimed at import substitution while protecting its domestic market. Its economic reform in 1991 accelerated hitherto moderate liberalization policies to better respond to globalization. Since the late 1990s, the Indian information technology (IT) industry achieved growth of more than 10% per annum as IT companies took outsourcing orders from developed countries such as the United States. However, it is not the IT industry but rather domestic services industries such as transportation and communications that have helped propel India's economic growth.

Characteristics of Indian Economy

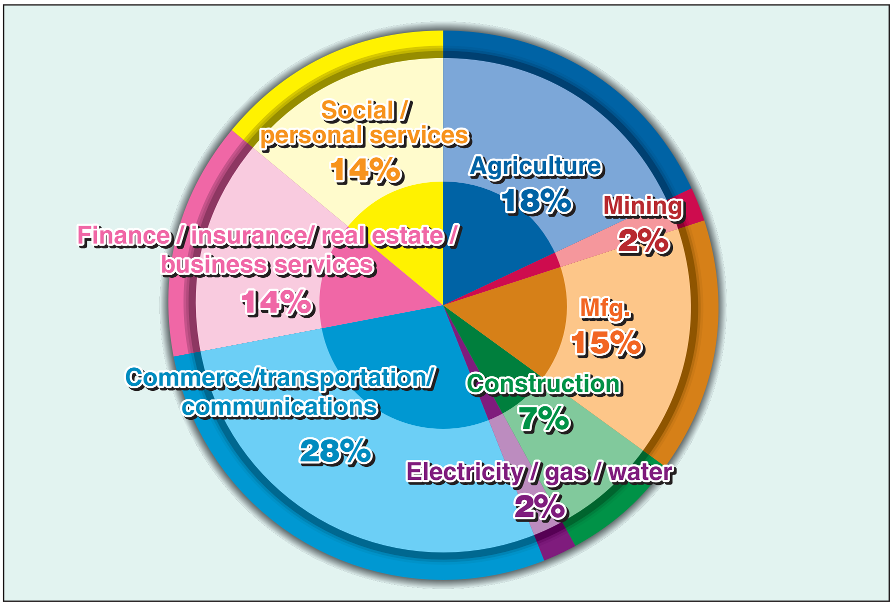
There are three factors that characterize the Indian economy. For one thing, the Indian economy enjoyed steady growth throughout the 1980s and 1990s. Its GDP growth in fiscal 1981 to fiscal 2003 averaged 5.6%. Such stable long-term growth brought about an emergence of a middle class with purchasing power. It is partly due to the effect of the Green Revolution. High-yield varieties of rice and wheat began to spread from the late 1960s, igniting the Green Revolution. Initially, the Green Revolution was limited to states with irrigation systems and planting concentrated on wheat. But over time, the revolution spread to other parts of India, and the production of high-yield rice and corn varieties became popular. The Green Revolution boosted food production in line with a rise in population, and the purchasing power of rural residents consequently rose. As a result, the percentage of poor people (defined as those unable to get enough nourishment) in proportion to India's overall population fell from 55% in fiscal 1973 to 22% in fiscal 2004.

The second factor is that the services sector tailored to the domestic market has contributed to India's economic growth. In fiscal 2006, the tertiary industry accounted for 58% of GDP (see the *chart*), with 28% consisting of trade, transportation and communications. The IT industry is growing at a rapid pace, but the IT and IT-related industries made up only 5% of GDP. The trade, transportation and communications industries have thrived on domestic demand. The growth of these industries reflects a climb in national income, which has led to active movements of goods and people. This is in sharp contrast to the Chinese economy whose economic growth has been driven by exports by the manufacturing sector.

The third factor is a high percentage of employment in the agricultural industry. Agriculture captured a 62% share in the total work force in fiscal 1999, compared with only 23% for the tertiary industry. As for changes in the composition of net domestic product (NDP), the share of agriculture declined to 25% in fiscal 1999 from 45% in fiscal 1972. On the other hand, the ratio of employment in the agricultural industry fell to 62% from 74%. While the growth of the services industry is remarkable, agriculture still plays a larger role in terms of employment.

These data show that there is redundant and underemployed manpower in rural areas. During economic development in Japan and South Korea, labor swung from excess to shortage, which paved the way for increased wages and improvement in the standard of living for the low-income class. In India, however, the problem of surplus labor remains unresolved. This explains why the poor were still estimated to make up 22% of the population in fiscal 2004 despite the drop in the poverty ratio.

Chart GDP composition in fiscal 2006



Source : Prepared by the author from data posted on the website of India's Central Statistical Organization

Photos: Uchikawa Shuji

The Green Revolution has led to greater output of rice and wheat, boosting the purchasing power of rural residents and helping maintain fast economic growth.

Investment in irrigation systems is important because it not only boosts agricultural output but also reduces poverty.

Three Challenges

The Indian economy faces three major challenges. One is how to create more employment. The labor force has increased along with the population growth, but there are not enough jobs to absorb the rise in the labor force. Accordingly, the unemployment rate for males based on their daily working status was 7.2% in rural areas and 7.3% in urban areas in fiscal 1999, but it was worse in fiscal 2004 at 8.0% and 7.5%, respectively. Simply raising the economic growth rate will not in itself help spur employment. Employment elasticity, measured by dividing the rate of growth in employment by that of economic growth, was at 0.52 in fiscal 1983-93, but dropped to 0.16 in fiscal 1993-2000. In the agricultural sector, it was at 0.7 in fiscal 1983-93 but fell to 0.01 in fiscal 1993- 2000, reflecting the increasing use of machinery on the farms. If agriculture cannot absorb surplus labor in rural areas, non-farm employment must increase. And to do that, it is necessary to raise the income of rural residents and allow them to increase spending on services and other non-food items.

The second challenge facing India is how to secure investment in agricultural infrastructure. Interest payments on government bonds are putting a strain on the national budget, and it is vital for the government to reduce the fiscal deficit. So far, the government has put low priority on investment in irrigation, as compared to roads and electric power plants. Investment in maintenance is far from sufficient, and there are many irrigation systems in need of repair. Investment in irrigation is important because it not only boosts agricultural production but also reduces poverty. In regions without irrigation systems, farm production is unstable, with low-income farms toppling into the poverty bracket during droughts. Setting up irrigation systems in such regions will help reduce poverty and create jobs.

The third challenge is getting hold of necessary energy. India produces oil and natural gas, but the supply is not sufficient to meet domestic demand. The economic growth has increased energy consumption, and imports of crude oil and natural gas are rising every year. The Indian government is pushing a national oil company, Oil and Natural Gas Corporation, to acquire overseas oil and gas assets actively It currently owns such interests in 15 countries, but many of them are still in the exploratory stage and it will take time before production starts.

Future of the Indian Economy

While the Indian economy is confronted with these problems, it is likely to expand. The middle class that has acquired purchasing power in the process of economic growth is burgeoning and the manufacturing and services industries catering to the middle class are likely to enjoy continued growth. With the exception of the apparel and leather industries, the manufacturing sector as a whole has so far been unenthusiastic about exports. Since fiscal 2002, however, manufacturing exports have grown by more than 20% per annum for four consecutive years. Nonetheless, the Indian manufacturing sector is still oriented toward the domestic market. Annual direct foreign investment in India is less than a tenth of that in China, and the possibility of India becoming an export base for the manufacturing sector is small. In light of the lack of infrastructure and of labor problems, it is too risky for foreign businesses to establish an export base in India. Therefore the Indian economy will continue to depend on domestic demand to achieve economic growth and rapid acceleration in growth is unlikely. But India's economy has been unscathed by external factors such as the currency crisis that suddenly shrank the Southeast Asian export market and a decline in exports caused by fluctuations in foreign exchange rates. Clearly, India is treading a different economic path than China. JS

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