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# India: Higher Saving Rate Holds the Key to a Sustained Growth

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India won independence from Britain in 1947 and, along with China, which underwent a civil war and, in 1949, made a transition to a socialist regime under the rule of the Communist Party, was a leader among the Asian and African nations that became independent after the World War II. The country at that time had one of the most competitive textile industry in the world and the only auto producing nation in Asia except Japan. Its GDP (gross domestic products) per capita was higher than that of China, which after the end of the civil war failed in its attempt in the Great Leap Forward and went through the confusion of the Cultural Revolution. In 1978, China shifted to a route of reform and liberalization and outgrew India in the size of the national economy but India was still leading in GDP per capita. The gap between China and India, however, grew wider in the late 1980s.

## *No improvement in the savings rate*

What caused this widening of the gap between China and India? China's shift to a route of reform and liberalization certainly had a major impact. This report, however, first focuses on differences between the two countries in the investment rate, or the gross fixed capital formation ratio, and the savings rate behind.

**Savings rates by country** (as a percent of nominal GDP)

| | 1960-69 | 70-79 | 80-89 | 90-99 | 2000-2003 |
|---|---|---|---|---|---|
| India | 13.8 | 17.3 | 20.0 | 22.1 | 22.1 |
| China | — | 30.5 | 34.7 | 40.9 | 42.6 |
| Korea | 8.4 | 21.5 | 30.0 | 35.5 | 32.0 |
| Hong Kong | 22.5 | 30.8 | 33.3 | 31.5 | 31.3 |
| Philippines | 18.5 | 24.9 | 21.0 | 16.2 | 18.9 |
| Thailand | 18.7 | 22.3 | 26.5 | 35.3 | 31.3 |
| Malaysia | 21.9 | 27.1 | 30.2 | 40.7 | 43.5 |
| Singapore | -4.0 | 28.6 | 41.7 | 48.3 | 45.9 |
| Indonesia | 8.0 | 25.0 | 31.6 | 30.2 | 23.5 |
| Japan | 35.4 | 35.7 | 31.8 | 30.8 | 26.2 |

Source: Above figures are calculated based on data contained in *World Bank World Development Indicators in CD-ROM (2005).*

India, since its independence, has consistently been plagued with savings shortage. The accompanying table shows ten-year average savings rates of major Asian countries and regions since the 1960s based on the World Bank WDI (World Development Indicators) data. India's savings rate was slightly below 14% in the 1960s, which did not rank so low in comparison with others, with a few exceptions including Hong Kong and Malaysia. In the 1970s and 1980s, however, many East Asian nations saw marked increases in their savings rates, while improvement in India was more limited and the savings rate there remained at levels a little over 20% in the 1980s and on. China, in contrast, has boasted one of the highest savings rates among the East Asian economies. Its savings rate exceeded 30% before the shift to a route of reform and liberalization and went even higher after the shift was made.

Domestic savings are the main source of investment and, generally speaking, the investment and savings rates move in tandem. Holding constant the productivity of investment, the level of savings rate determines the rate of economic growth.

The question, then, is why India's savings rate stayed so low. As various studies point out, determinants of long-term savings rate of a nation include i) economic factors such as per capita income, ii) cultural and social factors such as industriousness and abhorrence of extravagance and iii) the aged ratio, workforce ratio (the ratio of workforce population to the total) and other demographic factors. Barring the second factors as the main causes of the low savings rate, in which case a major improvement is unlikely in the foreseeable future, low income levels should chiefly explain India's low savings rate. Despite the historical increase, per capita GDP of India in Fiscal 2005 ended March 2006 at a little over six hundred dollars is about thirty-five percent of that of rivaling China. The ratio of the national population living on less than a dollar a day on a purchasing power parity basis, which the UN Millennium Project aims to reduce by half, is still thirty-five percent in India. As such, one of the keys to its future is the diffusion of benefits from economic growth to low-income population. The recent statistics show encouraging signs in that the country's saving rate has been on the rise in tandem with the acceleration of economic growth from 26.3% in Fiscal 2002 to 26.5% in 2003 and to 29.1% in 2004. In terms of demographic structure, while China is about to face the aging of the society, India expects its workforce ratio to rise up to 2040, which should help increase the saving rate of the country over the long term.

### *Slower than China in courting foreign capital*

The second reason for the low investment rate in India is slower introduction of foreign capital. China has developed infrastructure to facilitate foreign direct investment and successfully lured foreign capital by implementing various policy measures including preferential tax treatments to foreign businesses that operate in Special Economic Zones. The majority of companies that first expanded into China were small- to medium-sized businesses but large corporations later entered China with an eye on the advantage of China as a global sourcing center and potential of its domestic market. As such changes take place, 2000-2003 average inflows of foreign direct investment (FDI) on a balance of payment basis amounted to 3.7% and 9.4% of its GDP and nominal gross fixed capital formation, respectively, compared to 0.7% and 3.1% in the case of India. The actual amount of gross FDI inflows into India was slightly above 5.3 billion US dollars, or less than one-tenth of that into China.

Excess investment, or the amount of gross domestic investment in excess of gross domestic savings, matches the ex post current account deficit, which is then partly offset by capital account flows from FDI, portfolio investments from overseas and bank loans. The remaining deficit, excluding residuals, will then be balanced by changes in foreign reserves. Countries like India with underlying current account deficits will experience a widening in the deficit if the investment rate increases without an improvement in the savings rate. According to World Bank data, flow of overseas funds into India between 1997 and 2005 (2005 figures are estimate) was 86.6 billion US dollars, out of which FDI and corporate stocks acquired for portfolio investment purposes accounted for 38.6 and 39.7 billion US dollars, respectively, while China had inflows of 420.1 billion US dollars in FDI and 54.6 billion US Dollars in portfolio investments.

The current account of India briefly turned to a surplus but went back to a deficit in 2004 due to surge in oil prices and other factors. Recently, the country is running a current account deficit of over three percent of GDP. Underlying this is the issue of fiscal deficits of central and local governments that together exceed seven percent of the nation's GDP. India's dependence on portfolio investments which is mobile in nature is a weakness in the structure of its balance of payment. The key to a sustained growth of the Indian economy is how it can increase both investment and savings rates while keeping the current account deficit in check.

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