

# Challenges, Policy Response and Medium-term Prospects

## 2 CHAPTER

*During the last two years, the Indian economy has been buffeted by three major challenges originating in its external sector. First, a surge in capital inflows, which reached a crescendo in the last quarter of 2007-08. Second, an inflationary explosion in global commodity prices, which began even before the first challenge had ebbed, that hit us with great force in the middle of 2008. There was barely any time to deal with this problem before the third challenge, the global financial meltdown and collapse of international trade, hit the world with severity. Despite some difficult choices and ambiguities, arising from the rapid changes in the global situation, the short-term challenges arising from these global shocks have been met. Each of these, however, has implications for the medium term, that requires a considered and integrated response if our objective of sustained high growth is to be realized. An analysis of the impact of these shocks brings to the fore the importance of pursuing reforms, including in the financial sector, to make the economy more competitive and the economic regulatory and oversight system more efficient and sensitive to new developments.*

2.2 The Economic Survey of 2007-08 (February 2008) had pointed out that "There is now no doubt that the economy has moved to a higher growth plane, with growth in GDP at market prices exceeding 8 per cent in every year since 2003-04." It had however warned that "The new challenge is to maintain growth at these levels, not to speak of raising it further to double digit levels." Further, "The challenges of high growth have become more complex because of increased globalization of the world economy and the growing influence of global developments, economic as well as non-economic." Ten months later, the Mid-Year Review (December 2008), noted that "We should be prepared for growth in 2008-09 as a whole to be around 7 per cent." The experience of economic growth in a wide range of countries across the world and over different periods of history bears testimony to the fact that such setbacks are common. The experience of high growth economies (HGEs) suggests that these can be overcome by appropriate, pragmatic (non-ideological) and expeditious action to address the

problems that the shocks expose and by seizing the opportunities that they open up. This is what distinguishes the few economies that sustain growth over decades (by returning to high growth after a temporary setback) from the many that fall by the wayside (returning to slower growth after a temporary spurt of high growth).

2.3 The challenges that confronted the Indian economy in 2008-09 and continue to do so in 2009-10 fall into two parts. The short-term macro-economic challenges of monetary and fiscal policy and the medium-term challenge of returning to the high growth path. The former covers issues such as the trade-off between inflation and growth, the use of monetary policy versus use of fiscal policy, their relative effectiveness and coordination between the two. The latter includes the tension between short- and long-term fiscal policy, the immediate longer term imperatives of monetary policy and the policy and institutional reforms necessary for restoring high growth. This chapter reflects on some aspects of these issues.

## GLOBAL DEVELOPMENTS AND THE INDIAN ECONOMY, 2008-09

### Commodity prices and inflation

2.4 During the five-year period of high growth from 2003-04 to 2007-08, WPI inflation has gone through two cycles. The first peak in August 2004 was followed by a trough in August 2005 and the second peak in March 2007 followed by a trough in October 2007. The subsequent upturn in prices therefore followed the upturn in total capital inflows during 2007, which peaked at nearly 13 per cent in the July-September quarter of 2007-08. The focus of macro management in general, and monetary management in particular, has been on the implication of capital inflows on foreign exchange reserve accumulation, sterilization and the exchange rate. As capital inflows were far in excess of the current account financing requirements, and given the history of capital flow volatility into emerging markets, prudence required that a part of these excess inflows be accumulated as reserves. This also has the effect of moderating any potential volatility in exchange rates arising from capital flow reversals. However, the accumulation of foreign exchange reserves by increasing the monetary base also raised the issue of the degree to which the accumulation should be sterilized. The authority given to RBI to issue Market Stabilization Scheme (MSS) bonds backed by the Government of India was adjusted (in April and August 2007) to provide the required flexibility to RBI. The attempt to manage the build-up of liquidity over this period by running a cautious monetary policy, while balancing the liquidity requirements of a fast growing economy, bore fruit for most part of fiscal 2007-08 as the 52-week average WPI inflation remained at about 4.7 per cent and the GDP growth rate for the economy was 9 per cent. However, a sudden spurt in international commodity prices in the last quarter of calendar year 2007 started creating pressures on domestic prices of tradable goods, though an appreciation of the rupee during the last quarter of 2007-08, partly dampened the pass through of global commodity price increases.

2.5 Crude oil prices rose from an average of 90.7 US\$/bbl in January 2008 to a monthly average peak of 132.8 US\$/bbl in July 2008, touching a high of 147 US\$/bbl in this period. Similarly, among the imported edible oils, namely, palm and soyabean the prices rose from 1,059 US\$/MT and 1,276 US\$/MT in January 2008 to a monthly average high of 1,213 US\$/MT and 1,537 US\$/MT in June 2008, respectively. Inflation, which had declined to less

than 4 per cent in the middle of August 2007 and had remained so for 20 consecutive weeks thereafter, started firming up from December 2007. During December-March 2007-08, there was an increase in the prices of coal, iron ore, iron and steel products and prices of petroleum products not covered under the administered price mechanism. The rising oil prices necessitated an upward revision in the administered prices of petrol, high-speed diesel and LPG in first week of June 2008. Together with a continued hardening of global commodity prices these developments led to a sharp increase in the headline WPI inflation rate, touching double digit level by the middle of June 2008. It persisted at that level for the next 21 weeks with a high of 12.9 per cent in early August 2008. Nearly two-thirds of this rise in inflation was due to three sets of commodities namely, edible oils (including oilseeds and oilcakes), iron and steel (including iron ore) and mineral oils and refinery products (Figures 2.1 to 2.4).

Figure 2.1 : Global supply shock  
Edible oil (palm)

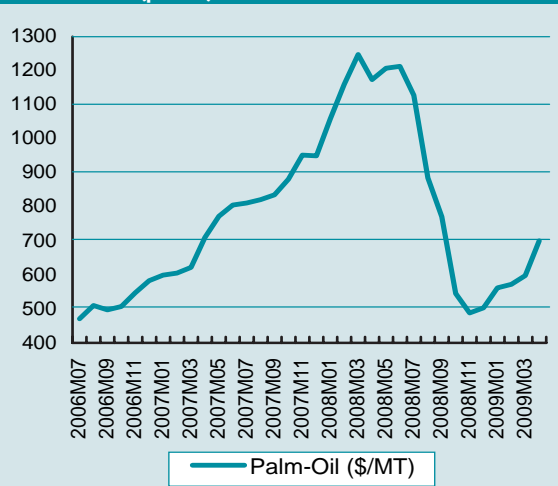


Figure 2.2 : Global supply shock-oil price

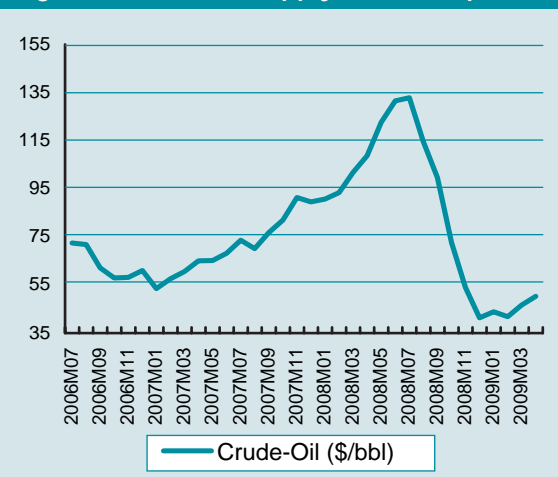


Figure 2.3 : Global supply shock- iron ore

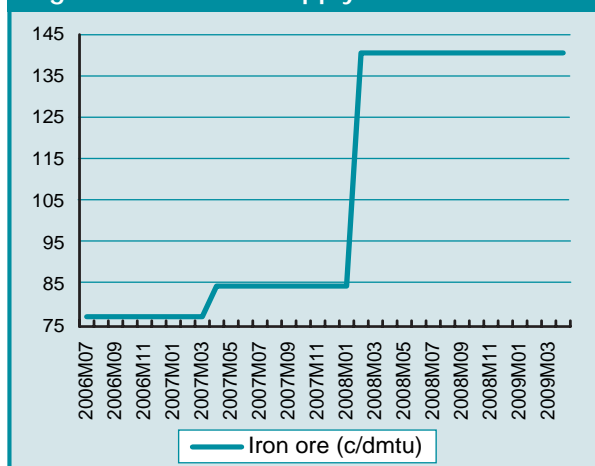
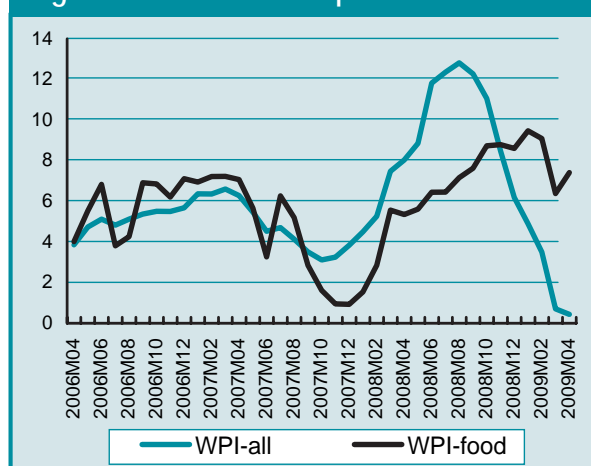


Figure 2.4 : Global cost push



2.6 Given the global origins of this inflationary episode, a judgement had to be made about the relatively temporary versus the relatively permanent elements. Appropriate fiscal and monetary measures had to be introduced to meet these elements. Given the degree of uncertainty about the exact proportion of temporary and permanent elements, a perfect response would have been unrealistic. On the monetary side, given the lags in monetary policy, the primary objective had to be the moderation in inflationary expectations and to ensure that money supply did not accommodate the permanent elements of the global cost push.

2.7 On the fiscal side, the temporary elements had to be met by making temporary reductions in the import duties on tradable goods whose prices showed unprecedented increases. Import duties were consequently reduced on the three sets of commodities mentioned earlier. The fiscal management of agricultural commodities subject to higher duties and some elements of quantitative intervention in the domestic or international sphere was more complicated. This is particularly true of basic agricultural consumer goods like cereals and pulses that affect millions of poor consumers and small farmers (producers). A combination of import tariff reductions, export duties and changes in quantitative measures for import and/or export had to be used to manage the trade-off between poor consumers and the livelihood concerns of poor producers. Though the management proved largely successful, a rational long-term framework needs to be developed, which balances the concerns of poor consumers and producers to promote efficient growth and livelihood security. One possible approach is to have an announced price band for domestic prices (which could itself evolve gradually over time) within

which imports and exports are freely allowed without any duties and controls. If international prices change beyond this band, domestic prices would be systemically dampened through imposition of variable import and export duties, depending on whether international prices fell below the lower band or rise above the upper band respectively. This along with targeted subsidies, such as the PDS, would help balance the interests of farmers who need a predictable price regime to plan their cropping patterns and those of low income households.

2.8 The rise in global oil price, along with the rise in prices of other imported commodities, had a strong adverse impact on the balance of trade. Oil imports are the predominant driver of total imports. Given the administered price mechanism for petrol and diesel, the sharp rise in oil, petrol and diesel prices required a decision on how much of this price could be passed through to users/consumers. Conceptually this too requires a judgement on how much of the rise is permanent. Ideally, the entire permanent element of the price rise should be passed through along with part of the temporary increase. With oil prices overshooting to double the long-term supply price of oil, the question of (directly or indirectly), temporarily taxing resource rents is also relevant. In practice, these issues were addressed somewhat imperfectly through a sharing formula that represented a mix of government subsidy, taxation of rents and some pass through. Consequently, the fiscal deficit, adjusted for below the line items, was negatively impacted by the global price developments. This also gave rise to a dilemma between two aspects of fiscal policy. From a macro perspective, the external shock could have been addressed by accommodating the short-term shock and tightening the fiscal policy to give a long-term

signal that the one time (temporary) price increase would not be allowed to translate into inflation (a continuing rise in prices). However, the political constraints and social arguments for dampening price pass through necessitated an increase in the fiscal gap. This in turn put greater pressure on monetary and other policies to moderate inflation (e.g. temporary controls under the Essential Commodities Act) that had little to do with domestic factors. Monetary management was also complicated by the fact that capital flows changed course in the first quarter of 2008-09 and trended down throughout the year. This affected foreign exchange reserves, exchange rate expectations and reserve money accumulation.

2.9 GDP growth was also affected by these developments as the worsening of terms of trade arising primarily from the rise in oil prices acts as an implicit tax on the citizens of the country, thereby reducing private consumption demand in the first half of 2008-09. Moreover, efforts to curb inflationary expectations necessitated a rise in interest rates and mopping up of liquidity in the economy, which influenced the growth rate, both from the demand side, as well as from the supply side.

2.10 The global financial meltdown resulted in a bursting of the commodity bubble, leading to a dramatic drop in most commodity prices. Crude prices dropped to around 40 US\$/bbl by December 2008. Thus, the global cost push that was primarily responsible for raising WPI inflation to double digit levels during 2008-09, went into reverse gear after July 2008. Consequently, by end-March 2009, the WPI Index was virtually back to the level that prevailed a year before.

### Financial crisis and the global slowdown

2.11 The global financial crisis surfaced around August 2007. Its origin lay in structured investment instruments (Collateralized Debt Obligations, synthetic CDOs) created out of subprime mortgage lending in the United States. The securitization process however was not backed by due diligence and led to large-scale default. The complexity of the instruments and the role of credit rating agencies played a contributory role. The high ratings assigned to certain CDO tranches, which were then quickly reversed with the onset of the crisis, created a panic situation among investors and precipitated the crisis.

2.12 While the initial effect of the crisis was profound on the US financial institutions and to a lesser extent on European institutions, the effect on

emerging economies was less serious. In the initial stages, the capital flows to the emerging economies actually increased, giving rise to what is termed as “positive shock” and the “decoupling” debate. In the case of India, for example, the net FII flows during the five-month period from September 2007 to January 2008 was US\$ 22.5 billion as against an inflow of US\$ 11.8 billion during April-July 2007, which were the four months immediately preceding the onset of crisis.

2.13 The effect of the financial crisis on emerging economies thereafter was mainly through reversal of portfolio flows due to unwinding of stock positions by FIIs to replenish cash balances abroad. Withdrawal of FII investment led to stock market crash in many emerging economies and decline in the value of local currency vis-à-vis US dollar as a result of supply-demand imbalances in domestic markets. In the case of India, the extent of reversal of capital flows was US\$ 15.8 billion during five months (February-June, 2008) following the end of “positive shock” period in January 2008.

2.14 Following the collapse of Lehman Brothers in mid-September 2008, there was a full-blown meltdown of the global financial markets. It created a crisis of confidence that led to the seizure of inter-bank market and had trickle-down effect on trade financing in the emerging economies. Together with slackening global demand and declining commodity prices, it led to fall in exports, thereby transmitting financial sector crisis to the real economy. Countries with export-led model of growth, as in many South-East Asian countries, and that depended upon commodity exports, were more severely affected. The impact on Indian economy was less severe because of lower dependence of the economy on export markets and the fact that a sizeable contribution to GDP is from domestic sources. India's trade reforms since 1991 have moved progressively towards a neutral regime for exports and imports, eschewing tax and other incentives for exports.

2.15 The direct impact of the crisis on financial sector was primarily through exposure to the toxic financial assets and the linkages with the money and foreign exchange markets. Indian banks however had very limited exposure to the US mortgage market, directly or through derivatives, and to the failed and stressed international financial institutions. The deepening of the global crisis and subsequent deleveraging and risk aversion however affected the Indian economy leading to slowing of growth momentum.



2.16 The overall balance of payment situation however remained resilient despite signs of strain in the capital account that manifested in the net reversal of FII flows of US\$ 15.0 billion during fiscal 2008-09 and on current account through decline in exports. In 2008-09, the merchandise exports recorded a growth of 3.4 per cent reaching US\$ 168.7 billion. While export growth was robust till August 2008, it became low in September and became negative from October 2008 to March 2009. The rupee depreciated by 21.2 per cent against the US dollar during fiscal 2008-09. The US dollar however appreciated by 17 per cent against the broad index (FRB, New York) between March 2008 and March 2009, suggesting that only 5 percentage points of the rupee depreciation was due to India-specific factors.

2.17 Money and credit markets have been affected indirectly through the dynamic linkages. The drying up of liquidity, a fallout of repatriation of portfolio investments by FIIs, affected credit markets in second half of 2008-09. This was compounded by the “risk aversion” of banks to extend credit in the face of a general downturn. The extent of the external financial and monetary shock on the Indian monetary-financial system is best captured by the precipitous contraction in reserve money by more than 15 per cent between August 2008 and November 2008 (compared to 0.5 per cent increase in the corresponding period of the previous year). Reserve money growth (y-o-y) collapsed from 26.9 per cent in August 2008 to 10.3 per cent in November 2008 and further to 6.4 per cent in March 2009. The various monetary policy measures taken by RBI kept narrow money  $M_1$  and broad money  $M_3$  from falling as precipitously. Despite these, however,  $M_1$  growth decelerated from 19.4 per cent in August 2008 to 10.3 per cent in November 2008 and further to 8.2 per cent in March 2009, while  $M_3$  growth decelerated from 21 per cent in August 2008 to 18.7 per cent in March 2009. A series of unconventional

measures actually helped to push up the rate of growth of bank credit from 25.4 per cent in August 2008 to 26.9 per cent in November 2008. However, this only partly offset the effects on short- and long-term credit to Indian companies in the United States and EU markets, because of the freezing of financial markets. Subsequently, credit growth decelerated sharply to 17.1 per cent in March 2009, partly because of transmission of OECD recession effects to Indian exporters and organized manufacturing.

2.18 Despite these developments, the macro-economic impact of the global financial turmoil, particularly on the GDP growth, has been relatively muted due to the overall strength of domestic demand and the predominantly domestic nature of investment financing.

### Impact on domestic growth

2.19 In the last two decades fluctuations in India's economic growth were not closely linked to the cycles in high-income OECD countries or the developed countries (Figure 2.5). The upward hump in Indian growth between 2003-04 and 2008-09, however, seems to coincide with a similar hump in global and OECD growth. The sharp decline in growth to 5.8 per cent in the second half of 2008-09 from 7.8 per cent in the first half of 2008-09, following the US and global financial meltdown in August 2008, seemed to support this perspective. Following the global recession, there was a view among global market analysts, that growth in emerging markets and developing countries was driven by the global excess liquidity/monetization, the associated capital flows from developed countries and the demand for commodities. Consequently, with the bursting of the bubble the initial impact would be a growth collapse, followed by a return in the medium term to growth rates that prevailed before 2004-05, because of the painful process of de-leveraging and collapse of capital flows. It was therefore concluded by some of

Fig.2.5 : GDP Growth - India, world & OECD countries

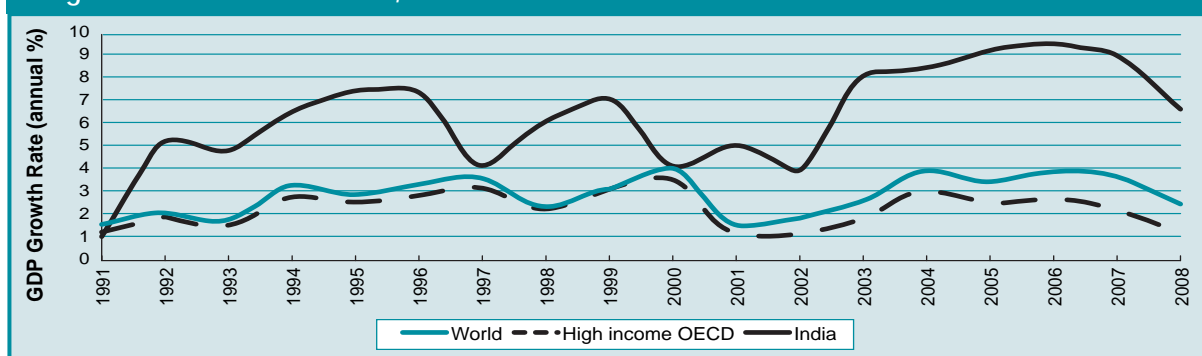
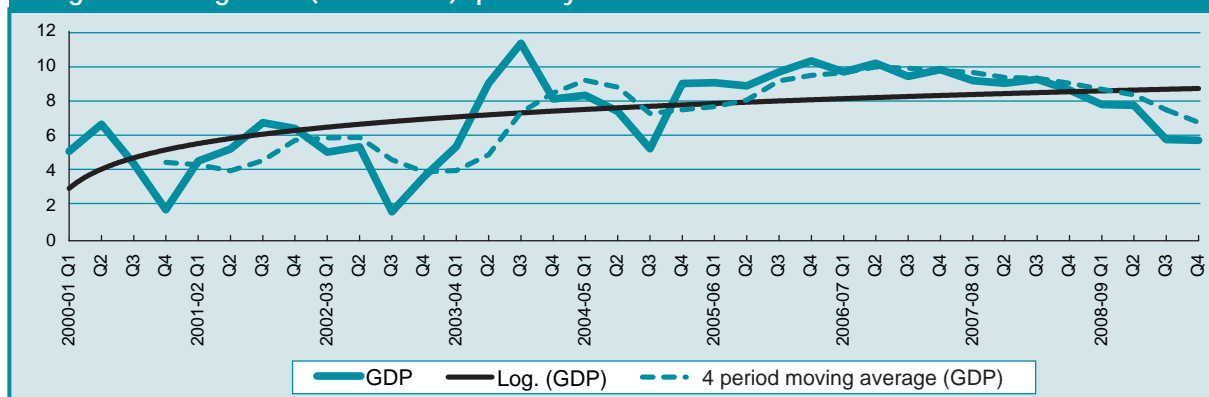


Fig.2.6 : GDP growth (factor cost) quarterly



these analysts that India's growth would collapse to around 4 per cent during the subsequent four to six quarters and thereafter it may revert to around 5 to 5.5 per cent over the medium term. An analysis of the growth history of India suggests that this superficial generalization of a plausible global analysis to India is erroneous.

2.20 The first half (H1) of 2008-09 saw the Indian economy recording a growth of 7.8 per cent in GDP, despite the build-up of uncertainty in the international commodity and financial markets. Among the domestic growth drivers, gross fixed capital formation (GFCF) retained some of its momentum from the preceding years with a growth of nearly 11 per cent. Consumption – both private and government – however declined significantly. The growth in private final consumption expenditure (PFCE) in H1 2008-09 was 3.3 per cent, which was less than half of the corresponding period in 2007-08. Similarly, government final consumption expenditure (GFCE) grew at less than 1 per cent, or just one-third of the growth in H1 of 2007-08.

2.21 In the second half (H2) of 2008-09, GDP growth declined to 5.8 per cent, with a further decline in private consumption growth to 2.5 per cent and a significant moderation in growth rate of GFCF to about 6 per cent over the corresponding period of 2007-08. However, with the roll-out of the fiscal stimulus, primarily in the shape of implementation of the Sixth Pay Commission recommendations in Q3, as well as the second round of fiscal expansion announced in Q4, the growth in government final consumption expenditure shot up to nearly 36 per cent, partly making up for the shortfall in other components of the domestic aggregate demand. The overall GDP growth for the fiscal 2008-09 at 6.7 per cent surpassed all estimates and forecasts, mostly ranging from 5.5 per cent to 6.5 per cent, made by international agencies and analysts.

2.22 An expected outcome of the recession in the economies of India's major export destination and consequent global excess capacity has been the sharp fall in the growth of organized manufacturing. The downtrend in the manufacturing sector started in the second quarter of calendar year 2007, with the slowing of the US economy and its imports of several products from India. The trend was merely accelerated after the US meltdown and the onset of the global recession. Services sector growth was not expected to slow sharply (as explained in the Mid-Year Review), because of its well known insensitivity to demand cycles and the relatively small contribution of service exports to GDP. There was a sharp increase in the growth of community, social and personal services, which includes GDP from government administration.

2.23 It is useful to compare the 2008-09 growth slowdown to earlier slowdowns in 2002-03, 1997-98 and 1991-92 (Table 2.1). If we use the difference between the five-year moving average growth rate and growth rate of the last of the five years as a measure of the slowdown, the 1991-92 slowdown was the sharpest, while the other three were of similar orders of magnitude. The growth rate of GDP at factor cost ( $GDP_{FC}$ ) is about 65 per cent higher than the average of the last two slowdowns. On all other previous occasions, agriculture GDP declined significantly and barring 2002-03 the decline in manufacturing GDP in earlier slowdown years was also sharper than in 2008-09. The deceleration of private consumption growth in 2008-09 is of concern, but it can be seen that growth rate is higher than in earlier years. The GDCF growth rate has however fallen to about half of what it was in the last two slowdowns. This is perhaps an indication of how strongly the heightened global uncertainty, risk perception and risk aversion have impacted Indian entrepreneurs. Despite the collapse in exports in

**Table 2.1 : Growth of GDP components during growth slowdowns**

(per cent)				
Items	1991-92	1997-98	2002-03	2008-09
GDP <sub>FC</sub>	1.4	4.3	3.8	6.7
GDP <sub>agri</sub>	-2.0	-2.6	-7.2	1.6
GDP <sub>mfg</sub>	-2.4	0.1	6.8	3.6
GDP <sub>MP</sub>	1.0	4.1	3.8	6.1
PFCE	2.1	2.3	2.6	2.9
GFCE	-0.2	11.2	-0.4	20.2
GDCF	-15.6	12.1	17.0	7.4
Export (G & S)	9.7	-2.3	21.8	12.8
Imports (G & S)	0.0	13.2	10.4	17.9

the second half of 2008-09, export growth for the year as a whole was fairly robust, while import growth was the highest among these slowdown years. This suggests that the deflationary effect of oil price increase played a greater role than analysts have acknowledged, though an indication was given in the Mid-Year Review. Though exports are in a downturn, the downtrend in imports has accelerated in the last quarter of 2008-09 and net exports have started to increase.

### Policy response to the slowdown

2.24 To counter the negative fallout of the global slowdown on the Indian economy, the Government responded by providing a substantial fiscal expansion in the form of tax relief to boost demand and increased expenditure on public projects to create employment and public assets. The net result was an increase in fiscal deficit from 2.7 per cent in 2007-08 to 6.2 per cent of GDP in 2008-09. The difference between the actuals of 2007-08 and 2008-09 constituted the total fiscal stimulus, notwithstanding the fact that some expenditure was on account of the implementation of the Sixth Pay Commission award and the agriculture debt relief scheme (small farmers' debt waiver) announced in the Union Budget 2008-09. Together about 0.5 per cent of the GDP was committed prior to the dramatic deterioration of the international financial markets in September 2008.

2.25 In implementing the fiscal stimulus, the Government increased its spending on the plan, both for Central sector as well as on Central assistance to state and Union Territories plans, by nearly 1 per cent of the GDP. There was an increase of nearly 2.5 per cent of GDP on non-plan expenditure that

included increased spending on fertilizers and food subsidies, agriculture debt waiver, defence, salaries and pensions. The Government renewed its efforts to increase infrastructure investments in tele-communications, power generation, airports, ports, roads and railways.

2.26 Questions are sometimes raised about the quality of the fiscal deficit. In making this judgement one has to be clear about the multiple dimensions on which quality can be assessed. One is the lag between fiscal action and increase in effective demand. Another is the degree to which the medium term productivity of the economy is increased. Expenditure such as debt relief, which has short lags, may have little or no effect on productivity, while productive infrastructure expenditure takes much longer to translate into effective demand. The approach of the government has therefore been to use a mix of fiscal measures, including reductions in indirect taxes (excise and service tax) which could be reversed subsequently.

2.27 The RBI took a number of monetary easing and liquidity enhancing measures including reduction in cash reserve ratio, statutory liquidity ratio and key policy rates. The objective was to facilitate the flow of funds from the financial system to meet the needs of productive sectors. In well developed financial markets like the United States, monetary policy instruments and their effectiveness in meeting the objectives is well known. However, the financial crisis in the US market had the effect of fragmenting these markets, so that conventional instruments were no longer effective. This was only partly an issue of the Keynesian liquidity trap. In a relatively less developed financial markets like India's the effectiveness of instruments is constrained by missing and imperfect financial markets. The global crises accentuated the non-integrated nature of the markets, requiring more careful attention to the different channels, namely interest rate, money supply and credit and the instruments appropriate to each. Further it became imperative to use both traditional (considered outdated by some) and unconventional instruments. The breadth and depth of the global crisis and the uncertainty and the fear surrounding it, required use of fiscal policy to supplement monetary policy. It was therefore necessary to ensure adequate coordination between the two, so that they did not work at cross-purposes. Though it would be far from the truth to claim perfection, by and large the conceptually sound approach was eventually implemented.

2.28 The Government also announced specific measures to address the impact of global slowdown on India's exports. These included extension of export credit for labour-intensive exports, improving the pre- and post-shipment credit availability, additional allocations for refund of terminal excise

duty/CST and export-incentive schemes, and removal of export duty and export ban on certain items. Though it is not possible to substitute for the dramatic fall in foreign demand, these measures would be helpful in facilitating the adjustment of companies and workers to the new reality and to survive the temporary setbacks.

### Box 2.1 : Policy response to the financial crisis

Time frame	Objective/means	Policy options	Government's response
Immediate	Addressing financial panic and uncertainty	Guaranteeing of bank deposit Guarantee inter-bank loans. Providing liquidity to banks Forbearance on regulations	Not required due to the limited direct exposure of Indian financial institutions to the US financial markets. Top policymakers and the RBI reassured the market in right earnest.
	Trade policy	Maintaining competitive exchange rates and encouraging free trade. Reversing protective measures introduced during the year for inflation management	Government did not intervene in the foreign exchange market, allowing the market to determine the rupee exchange rate
Short term	Monetary policy	Reductions in the costs of borrowing, improving market liquidity & credit flows	Between August 2008 & March 2009, RBI's successive policy announcements reduced reverse-repo and repo rates from 6 to 3.5 and 9 to 5 per cent, respectively; CRR reduced from 9 to 5 per cent. This helped in improving liquidity in the system
	Fiscal policy	Expansionary fiscal policy with increase in public spending on works, social safety nets and employment	Overall fiscal stimulus of nearly 3.5 per cent of GDP
	Institutional measures	Recapitalization of banks Consolidation of financial sector institutions	The Central Government contributed to recapitalization of RRBs; 196 RRBs merged into 85 RRBs. Government recapitalizing public sector banks over two years to maintain CRAR of 12 per cent; NPAs for these banks declined from 7.8 per cent on March 31, 2004 to 2.3 per cent on March 31, 2008.
Medium term	Domestic financial sector reforms and other measures	Increasing access to finance Improving domestic resource mobilization Improving efficiency of banking sector Avoiding financial repression Improving supervision and regulation Strengthening property and contract rights, judiciary and rule of law	Interest subvention extended on pre- and post-shipment credit for specific sectors Improving regulatory oversight of capital markets; putting a divestment plan for PSEs in place.
	Reform of international financial architecture	Deepening of financial markets and reforms Moving towards a more inclusive system of global financial governance Satisfactory conclusion of Doha WTO Round Improving aid effectiveness and development cooperation architecture reform of Bretton Woods Institution	Initiatives under the G-20 forum of which India is an active participant



2.29 By deciding to relax the FRBM targets for 2008-09 in order to provide the much needed demand boost to counter the situation created by the global slowdown, the Government may have succeeded in arresting the decline in the growth rate of GDP to around 7 per cent. There has been a good rabi harvest and the agriculture sector has recorded a growth of 1.6 per cent in 2008-09 over a high growth of around 5 per cent in 2007-08. The forecast for the monsoon is normal though its progress so far seems to be behind the usual schedule. There has been an increase in Foreign Direct Investment (FDI) during 2008-09 over the previous year. More importantly, there are signs that Foreign Institutional Investors who had recorded net outflows in 2008-09 may have returned to the Indian market in the last two months. The credit market appears to be working normally and there is no dearth of liquidity in the economy. Inflation is no longer an area of concern. With the Index of Industrial Production showing clear sign of revival in the month of April, it is likely that the two worst quarters since the global financial meltdown in September 2008 are behind us. Indeed, the stock market in the last few weeks (of May-June 2009) may have already picked up these early signs of the rebound.

## SOME ASPECTS OF INDIA'S RECENT GROWTH DYNAMICS AND PROSPECTS

### Aggregate demand and supply

2.30 The step-up in the trend growth rate of the Indian economy since around 2003-04, highlighted in Economic Survey 2007-08 has come about due to significant improvement in our domestic investment and saving rates. The investment rate has increased from 25.2 per cent in 2002-03 to over 39 per cent in 2007-08 (Figures 2.7i, ii & iii). If one looks at the growth "drivers," at an incremental level there was a significant increase in the investment growth rate. It nearly tripled from an average of around 6 per cent in the five-year period leading up to 2002-03 to just nearly 17 per cent in the next five years. The role of private consumption was also supportive with its growth rate increasing from less than 5 per cent to nearly 7 per cent in the said periods, though its relative contribution in sustaining growth came down below that of investment for the first time. Moreover, this spurt in investment growth was primarily that of private fixed investment and not a build-up of inventories. There was, therefore, an increase in the productive capacity of the economy which in the medium term would help the economy

Fig.2.7(i) Investment Rate - GDCF as a proportion of GDPmp

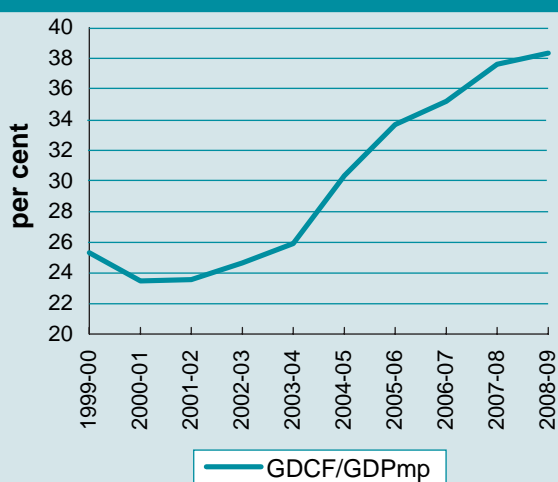


Fig.2.7(ii) Growth rate of GDPfc, investment & consumption

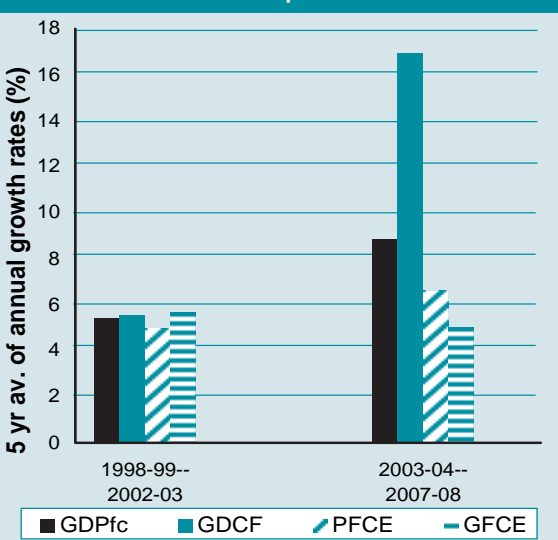
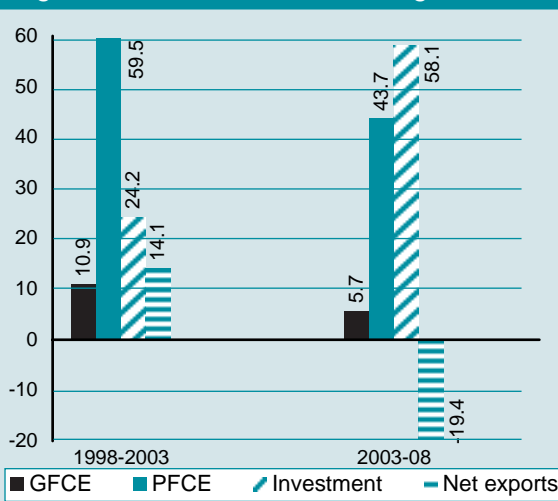


Fig.2.7(iii) Contribution to GDP growth



climb back to its trend rate. To consider one example, gross capital formation at constant 1999-2000 prices in agriculture as a proportion of agriculture GDP improved from 11.1 per cent in 2003-04 to 14.2 per cent in 2007-08. It is also worth noting, particularly in the context of the global slowdown, that the net contribution of the external sector to aggregate demand of the economy has been negative since 1990, except for a brief period, from 1997-98 to 2002-03, when it was positive and about 14 per cent. In the high growth period since then it has been negative, about 19 per cent. This notwithstanding, India's integration into the world economy over the last decade has been surprisingly rapid. For example, India's external trade (merchandise exports plus imports) as a proportion of GDP grew from 18.6 per cent in 1997-98 to 38.9 per cent in 2008-09.

2.31 In the last five years, the gross domestic savings as a proportion of GDP has increased from 26.3 per cent in 2002-03 to 37.7 per cent in 2007-08. During this period, the percentage share of public sector in gross domestic savings increased from (-)2.5 per cent to 11.9 per cent (Quick Estimates). The significant increase in the inflow of foreign capital that this period witnessed was important not so much for bridging the domestic savings-investment gap, but for facilitating the intermediation of financial resources to meet the growing needs of the domestic industry and service sector for long term and risk capital. Moreover, though domestic funds were available, they were expensive relative to foreign funding. Thus, from a macroeconomic perspective, the average current account deficit during 2003-04 to 2007-08 was 0.4 per cent of GDP, while the investment-saving gap was even smaller when viewed from the National Accounts. Even in 2007-08, which showed the highest deficit for this period, the current account deficit was only about 1.5 per cent of GDP, the rest almost 7 per cent was rechanneled abroad in the form of foreign exchange reserves. However, these capital flows in excess of the current account deficit reflect the importance of external financing and the depth of India's financial integration with the rest of the world. Indeed, India's financial integration with the world was as rapid as its trade globalization, if not more. As a broad measure of globalization, the ratio of total external transactions (gross current account flows plus gross capital flows) to GDP more than doubled over a 10-year period from 46.8 per cent in 1997-98 to 117.4 per cent in 2007-08.

### Sectoral composition

2.32 In terms of sectoral growth drivers, manufacturing, communications, trade, agriculture

and construction have been the major contributors to the spurt in the growth rate. During the period 2003-04 to 2007-08, the annual growth rate of agriculture was more than 4 per cent. The production of foodgrains increased by about 10 million tonnes each year to reach an all-time high of over 230 million tonnes in 2007-08. Manufacturing, registered as well as unregistered, recorded a growth of 9.5 per cent per annum and communication and construction sector grew at the rate of 27 per cent and 13.5 per cent per annum, respectively in the period 2004-05 to 2007-08. The growth of investment in manufacturing was around 30 per cent per annum. Similarly, the capital stock in end-2007-08 over end-2002-03 was nearly one-and-a-half times more in construction, manufacturing and in trade, hotels and restaurants. Some of these sectors recorded significant improvement in efficiency as captured, somewhat crudely, by improvement in the incremental capital-output ratios, benefitting from a competitive environment and technological upgradation.

### Spatial dimension of the growth spurt

2.33 If one considers the period since 2000-01, the average per annum GDP growth rate at the all-India level increased substantively from 5.6 per cent in sub-period I (2000-01 to 2003-04) to 8.9 per cent in sub-period II (2004-05 to 2007-08). A total of 27 states and Union Territories out of 32 improved their performance in the sub-period II vis-à-vis sub-period I (see the states reflected above the 45 degree line in Figure 2.8i) as per the data available with CSO as of May 2009. Of these 27, nine states and Union Territories namely, Delhi, Karnataka, Tamil Nadu, Jharkhand, Bihar, Maharashtra, Goa, Madhya Pradesh and Manipur more than doubled their growth rates in the sub-period II. Chandigarh was the only state/Union Territory that maintained a two digit growth rate in both the periods.

2.34 It is instructive to look at the movement of these states and Union Territories (Figure 2.8ii) between low, medium and high growth categories in the two sub-periods. Although, Madhya Pradesh and Manipur managed to more than double their growth rates in sub-period II, it was not enough to pull them out of the low performing category, relative to the all-India average (i.e. below 4 per cent per annum in sub-period I and below 6 per cent per annum in sub-period II). In case of Rajasthan, Puducherry, Nagaland and Mizoram the high growth rates of sub-period I (i.e. above 6 per cent per annum) could not be sustained in sub-period II (i.e. above 8 per cent per annum). Indeed, these four states /Union Territories

Fig. 2.8 (i) Trend in state level growth in gross state domestic product

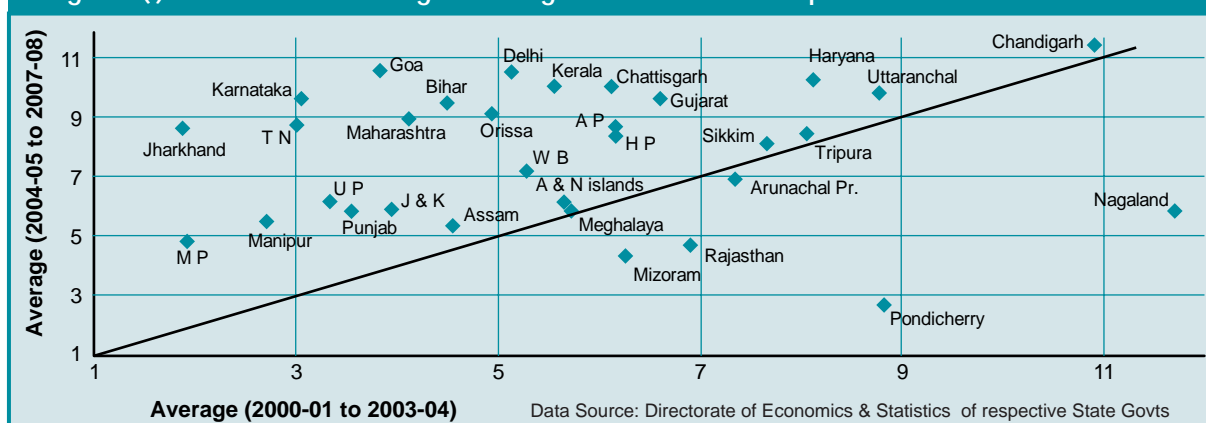
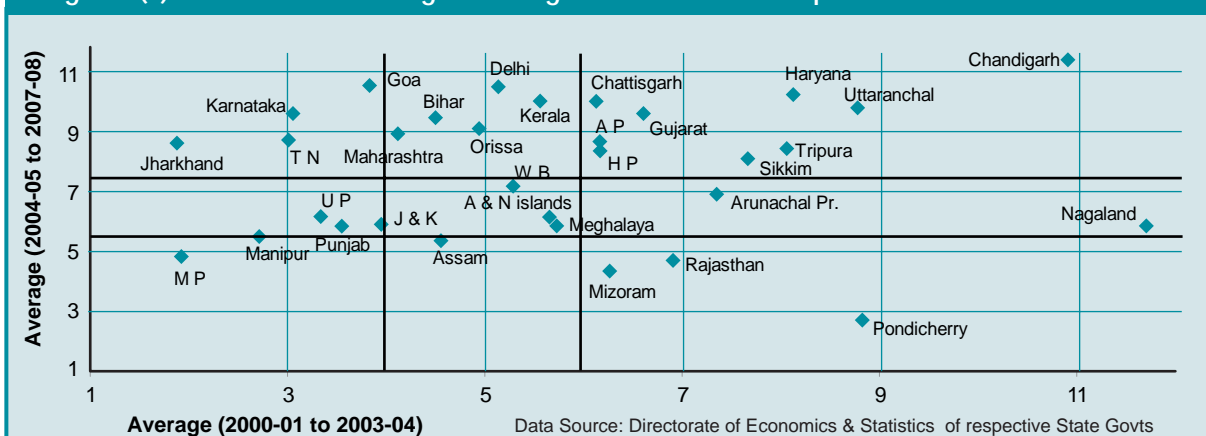


Fig. 2.8 (ii) Trend in state level growth in gross state domestic product



have slipped from high performing category in sub-period I to low performing category in sub-period II. Similarly, Assam and Meghalaya have moved from medium category (i.e. with growth rate between 4 and 6 per cent) in sub-period I to low category in sub-period II. It is somewhat of a surprise to see Punjab among the low performing states in both sub-periods, even though it improved its growth rate from about 4 per cent to nearly 6 per cent. Haryana,

Uttarakhand, Tripura, Sikkim, Gujarat, Himachal Pradesh, Andhra Pradesh, Chhattisgarh and Chandigarh have retained their position in the high performing states/Union Territories in both sub-periods. While highlighting the growth transition at state level, the analysis provides an indication of the considerable scope that exists in improving growth rates in many states and Union Territories and thereby also at the national level (Box 2.2).

### Box 2.2 : Growth and Poverty : Policy Implications for Lagging States

Interstate differences in improvement in poverty incidence can be largely explained by differences in growth of per capita gross domestic product, agricultural growth and the share of the bottom 40 per cent of the population in consumption. These determinants of poverty are directly under the purview of the states, in terms of policy or government expenditure or both. There are also aspects of Central Government policies (e.g. labour) that impede aggregate economic growth or poverty reduction. However, each state has the option of adjusting its own rules and procedures to minimize the negative effects of these Central policies as well as to improve the impact of policies that come directly under its purview. States that have done so have been more successful in accelerating growth during the 1990s, while others have seen little acceleration. Performance of some states has even declined because of worsening governance and deteriorating investment climate in the state. The paper concludes that the most critical areas distinguishing state growth performance have been modern (registered) manufacturing and commerce captured best by the National Accounts sector of "Trade, Hotels and Restaurants." To multiply the benefits of these two growth drivers, there is a need for a positive policy environment for the development of trade, hotels, restaurants, construction, real estate and townships. There is also a need for focusing on urban/civic planning and physical connectivity. The paper recommends that to eliminate poverty, economic policy should focus on, (a) accelerating growth, (b) programmes for agriculture and rural development and building roads (state, district and local) in the poorer states, and (c) target subsidies at the bottom 40 per cent of the population.

Source : Arvind Virmani, *Economic and Political Weekly*, Vol. XLIII, No 2, January 12, 2008, page 54-62.

### Short- to medium-term prospects

2.35 There are early signs of recovery in the global economy that are manifested in rising stock prices, particularly among the major emerging economies, and increasing price of commodities including crude oil. It is however debatable whether rising prices are an indication of green shoots of recovery or a result of position taking by financial investors, seeking to benefit from global recovery expectations due to large fiscal and monetary stimulus and/or to hedge against inflation risk in the United States due to massive quantitative easing.

2.36 There are nevertheless some inconclusive indications that financial investors have been at play, as oil prices have risen sharply, despite build-up of inventories and forecasts of lower global demand. Other commodities have been no exception. Aluminium prices, for example, have risen sharply in recent months despite build-up of large inventories and the fact that the sectors using aluminium – construction and manufacturing – are more severely affected by the crisis. The speed of rise in commodity prices, as was the rapid decline last year, is another pointer to the possible role of financial investors. The fear is that the rise in key commodity prices, including oil, may adversely affect prospects of global recovery at a nascent stage. The risk is more in the case of oil, since rise in crude prices would strain the balance of payments of a large number of oil importing emerging economies.

2.37 Though the financial crisis and the transmission of its impact on the real economy is now better understood and global financial conditions have shown improvement over the recent months, uncertainties related to the revival of the global economy remain. That makes it difficult to forecast the short- to medium-term growth prospects of the Indian economy. However, a review of the strengths and some concerns of the economy is helpful in making an overall assessment.

2.38 Compared to other emerging economies, India has several strengths that can help an early mitigation of the adverse effects of the global financial crisis and the recession in major OECD economies. To begin with, India has a relatively high share of services in GDP than many other emerging economies and developing countries. Historically, across countries, services tend to be less affected by cyclical downturns than manufacturing. This factor has operated in the second half of 2008-09 and is likely to continue in 2009-10. Secondly, six years of average 4.4 per cent agriculture growth together with

scaling up of rural development programmes, including the National Rural Employment Guarantee Scheme (NREGS), during the past year has kept the rural income and consumption strong. This is reflected in the momentum in rural prices (CPI for agricultural/rural labour) and the rise in WPI food inflation despite favourable agriculture growth. Thirdly, like other high-growth Asian economies, India's domestic saving rate remains high and has risen sharply with higher growth during the last five years. In fact the increase in the gross domestic saving over the last five years was greater than the increase in gross domestic capital formation over the same period (2007-08/2002-03). Fourthly, the ambitious programme of infrastructure investment designed for the Eleventh Five Year Plan period, which has now been front-loaded as a part of the policy response to the growth slowdown, provides the basis for offsetting some decline in corporate investment in manufacturing by increased investment in infrastructure by government and by the private sector through the public-private partnership model. This, however, requires greater urgency in removing the policy and institutional hurdles to investment by private sector as well as government agencies.

2.39 Fifthly, India continues to retain its position as a preferred destination for investments. In a recent UNCTAD study on assessing the impact of the current financial and economic crisis on global flows, it was found that India achieved a growth of 85.1 per cent in foreign direct investment flows in 2008, the highest increase across all countries. According to this study, FDI investments into India went up from US\$ 25.1 billion in 2007 to US\$ 46.5 billion in 2008 even as global flows declined from US\$ 1.9 trillion to US\$ 1.7 trillion during the period. Sixthly, the steep decline in commodity prices in the second half of 2008-09 along with the likely slack in global demand for at least the next 12 months would not only help in cutting down the import bill, but also have a favourable impact in effecting a reduction in below the line deficit to less than the level in 2008-09. The reduction in oil and fertilizer subsidies would help bring the Central fiscal deficit back towards the long-term trend. Finally, over the past five years of growth net exports were a depressant on domestic demand contributing (-)17 per cent to the total increase in demand over the five years. The previous five years were perhaps the only such period when net exports made a substantial positive contribution to domestic demand. The former was primarily due to high oil prices and the latter due to exceptionally low oil prices complemented by significant export growth.



The decline in oil prices in the depressed post-September 2008 global markets, complemented by other commodity prices, may partly offset the sharp deceleration in export growth. The net contribution of exports is likely to be non-negative, which is a substantial improvement over the negative contribution in the recent years.

2.40 A major concern at this stage, though not entirely unexpected, is the sharp dip in the growth rate of private consumption. Four factors seem to have contributed to this slowdown. First, it could be due to the wealth effect, resulting from a decline in the equity/property prices. Secondly, the uncertainty in the labour market and some decline in employment in India's tradable sectors may have moderated the growth in consumption expenditure. Thirdly, cutbacks in consumer credit by private banks NBFCs and other lenders, because of their limited deposit base and difficulties in secondary market financing because of the knock on effect of global financial market freezing. Fourthly, during slowdown a dominance of precautionary motive may induce consumers to either defer their spending decisions or shift to unbranded lower quality alternatives. Similarly, the slowdown in the growth rate of gross fixed capital formation (GFCF), though anticipated, is an area of policy concern from the point of an early return to the high GDP growth path. Several reasons could have contributed to this deceleration in growth of GFCF. First, surge in domestic inflation in Q1 and Q2 of calendar year 2008 reinforced the tightening of monetary policy, a trend that was already underway. It affected the cost and availability of funds for investment. Secondly, since inflation was largely on account of metals and fuels (or intermediates and basic goods), bulk of it was absorbed by industry, which affected its internal accruals and profitability, reducing to that extent the investible funds. Thirdly, despite monetary policy becoming accommodative in Q3 and Q4, decline in interest rates were not up to the industry expectations. Though, nominal rates eased by 100-150 basis points real rates continued to be high. Moreover, the expectation that there could be further cuts in policy rates and in lending rates may have resulted in investment decisions being deferred.

2.41 There are also certain downside risks for the Indian economy in the post-September 2008 global environment. First of all, equity disinvestment and repatriation have reduced availability of risk capital for the corporate sector worldwide. Secondly, medium- to long-term capital flows are likely to be lower as long as the de-leveraging process continues

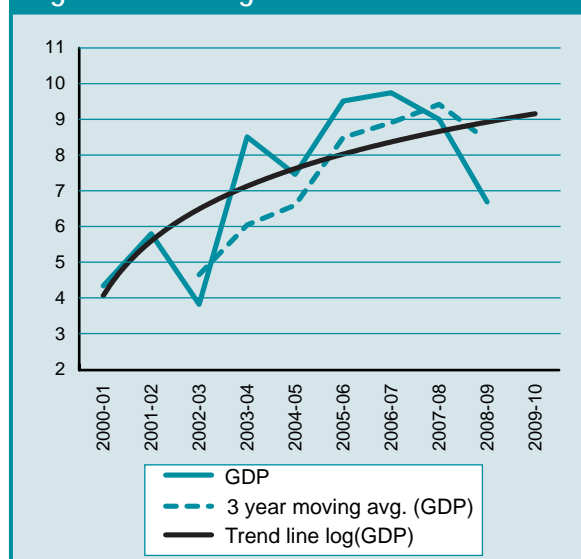
in the US economy. Thirdly, a delayed revival of the OECD economies will have a negative effect on their imports and consequently on exports of emerging economies. In fact, specific export intensive manufacturing sectors (e.g. gems & jewellery, leather products and garments) could remain affected for some more time.

2.42 The prospects of Indian economy are somewhat different from most other countries. In the first place, Indian economy has slowed and has not shrunk unlike most OECD and many emerging economies. A large domestic market, resilient banking system and a policy of gradual liberalization of capital account have been a key factor. A number of forecasts and projections have been made on the prospects of the Indian economy in 2009-10. These range from a low of 4.8 per cent (ICRIER, March 2009) to a high of 6.5 to 7.5 per cent (ICRA, April 2009). The RBI's April 2009 projection stands at 6 per cent and that of PM's Economic Advisory Council at 7-7.5 per cent. Among the international agencies, the March 2009 ADB forecast for 2009-10 is 6.5 per cent, IMF is 5.6 per cent and World Bank's forecast for the calendar year 2009 is 4 per cent.

2.43 The speed at which the Indian economy returns to the high growth path in the short-term depends on the revival of the global economy, particularly the US economy, and the Government's capacity to push some critical policy reforms in the coming months. If the US economy bottoms out by September 2009, there could be good possibility for the Indian economy repeating its 2008-09 performance, i.e. around 7.0 +/- 0.5 per cent in the fiscal 2009-10 (assuming a normal monsoon). The pattern of fiscal 2008-09 may be repeated in that case, though in an inverse sequence, with two not so good quarters followed by two good quarters making a 'U'-shaped revival of the growth path. However, in the event of a more prolonged external economic downturn, with revival of the global economy/US economy being delayed until early 2010, the growth may moderate to the lower end of the range.

2.44 This recovery is likely to be assisted by the likely developments in the external sector. The declining trend in trade deficit suggests that with reasonable invisible account surplus, which has been an attribute of the Indian economy for the last several years, economy may end up with a current account surplus of 0.3-2.8 per cent of GDP in 2009-10. The preliminary findings are based on the assumption of monthly trade deficit of US\$ 4-6 billion in 2009-10

Figure 2.9 : GDP growth and trend



and an alternative scenario of crude basket price of US\$ 70-80 per barrel to stress test the results. Further, with positive foreign institutional investment inflows and expectation of general recovery, capital account is likely to generate a surplus in 2009-10, a phenomenon that has characterized the Indian economy for the last several years. The global crisis has therefore created a situation where the economy could possibly experience both current and capital account surplus for the first time since 2003-04.

2.45 In the medium-term, with the global economy recovering from the current slowdown and given the growth dynamics of the economy in the recent years, India should be back on the new trend growth path of 8.5 to 9 per cent per annum (Figure 2.9), provided the critical policy and institutional bottlenecks are removed. It is therefore imperative that the government revisit the agenda for pending economic reforms in the first instance, with a view to renew the growth momentum.

## SUSTAINING THE GROWTH MOMENTUM — SOME ASPECTS OF THE POLICY AGENDA

### Fiscal and monetary policy issues

2.46 Fiscal policy plays a dual role as a short-term counter-cyclical tool and an instrument to maintain macroeconomic stability and promote growth over the medium term. This becomes all the more important because of the reality of business cycles in an era of globalization. Indeed, in order to balance these two objectives two key aspects of fiscal policy need to be addressed and strengthened.

The first would be to restructure the tax and expenditure policy to strengthen the “automatic stabilizers” and the other would be in the area of improving fiscal transparency.

2.47 Tax policy initiatives since the economic reforms of the 1990s have helped in considerably simplifying the tax system and broadening the base. Within this broad trend there have been occasions when revenue imperatives have led to the imposition of surcharges and cesses and a number of new taxes such as CTT, STT, FBT and DDT, which have partly reversed the move towards a simpler system. In addition, higher interest payments, a result of an erratic process of fiscal consolidation, particularly from around 1997-98 to 2002-03, and an ever-increasing magnitude of subsidies, both explicit and those funded through bonds in the recent years, have reduced the headroom for short-term counter-cyclical fiscal policy. At times, higher inflation (such as in the first half of 2008-09) and on other occasions political imperatives, have prevented a better alignment of fuel, fertilizers and food (Targeted Public Distribution System) prices with the border/market prices. With a moderation in global commodity prices and moderation in domestic inflation, it is, perhaps the best time to address some of these issues.

2.48 With the enactment of Fiscal Responsibility and Budget Management Act, Indian fiscal stance has become more transparent, rule-based and predictable. As the anchoring of the fiscal policy to FRBM Act has facilitated the Government in pursuing the medium-term growth and stability objectives, as apparent in the experience of the last five years, it would be imperative to get back to the path of fiscal consolidation with FRBM II at the earliest.

2.49 The Centre’s fiscal deficit will have to be restored to the FRBM target of 3 per cent of GDP at the earliest. A number of factors will make it possible to do so: (a) The Pay Commission arrears would have been paid out in 2009-10 (60 per cent of total) with no further liability in 2010-11; (b) most of the farm loan waiver amounts would be paid out in 2009-10 leaving marginal amounts for the next year; (c) much of the decline in business and corporate tax collections is cyclical and will tend to be reversed when growth accelerates from the second half of the year; (d) the expected introduction of the GST in 2010-11 provides an opportunity for setting indirect tax system on the path to producing a sustained increase in revenues, reversing the temporary stimulus provided during 2008-09 and 2009-10.

2.50 In an open-economy context, monetary policy is the first line of defence in addressing volatility in domestic markets and for managing short-term cyclical downturns. Often, its effectiveness in addressing the objectives is undermined by the lags that exist in transmitting the policy impulse to the relevant financial and the real sectors of the economy. These lags may vary from one to several years and the transmission channel itself may not always be very clear. In India, monetary transmission has had a differential impact across various segments of financial market. The transmission has been more efficient in the money and bond markets and somewhat sluggish in the credit market with its implications for the real economy. The credit market suffers from structural rigidities, for instance on account of small savings deposit rates which are often sticky in their downward movement. Indeed, such rigidities may also have been reinforced in the last few years due to a high credit demand, encouraging the banks to raise deposits at higher rates for maintaining long-term liquidity. These high

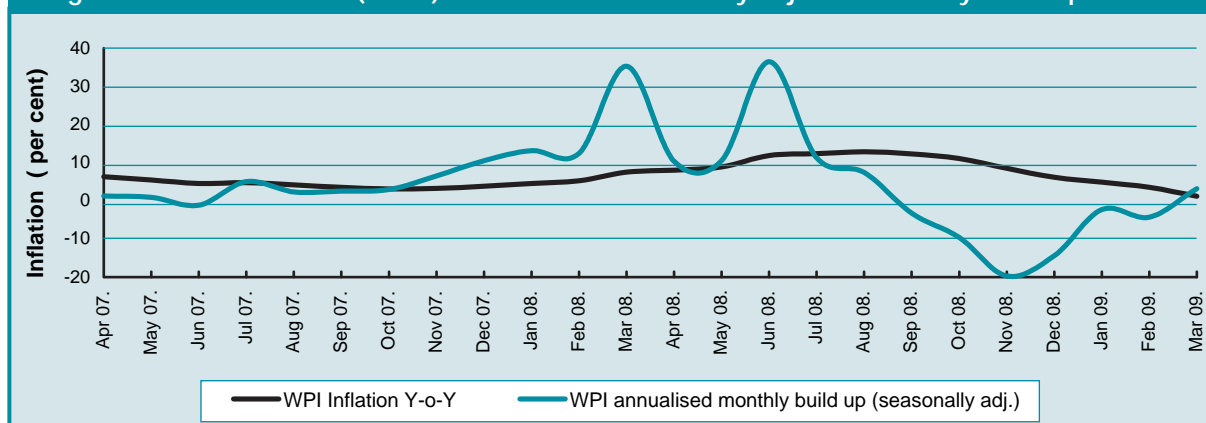
rates have now come in the way of cutting lending rates at a pace which is consistent with the current outlook on inflation and the need for stimulating investment demand.

2.51 The issue of deseasonalized data has caught media attention in recent years. About a decade ago a research project of the Economic Division, Department of Economic Affairs, had found that deseasonalized IIP data did not add much to forecasting accuracy. About three years ago analysis with deseasonalized WPI data showed that it could occasionally improve lead time by a few months. Figure 2.10, however, illustrates the difficulties. During 2007-08 and 2008-09, there were two occasions when deseasonalized data was giving very similar signals. In both cases the sharp upward spike in deseasonalized data, way above the general trend resulted in an upward shift in annual rate. However, results of the downward movement in deseasonalized data were quite different in the two cases. In the first instance, it was reversed, while in the second it was indicative of a trend. Nevertheless use of

### Box 2.3 : Fiscal sustainability and tax simplification

- FRBM-2: Examine the possibility of a new target of zero fiscal deficit on a cyclically adjusted basis.
- Reform of Petroleum (LPG, kerosene), fertilizer and food subsidies to reduce leakages and ensure targeting, so that all the needy get the intended benefit. Limit LPG subsidy to a maximum of 6-8 cylinders per annum per household. Phase out Kerosene supply-subsidy by ensuring that every rural household (without electricity and LPG connection) has a solar cooker and solar lantern.
- Convert fertilizer subsidy from a part-producer subsidy to a wholly farmer-user nutrient related subsidy, with freedom to producers to set prices of formulations with different mix of nutrients.
- Auction 3G spectrum. The auctioned spectrum must be freely tradable, with capital gains on spectrum to be taxed under the Income Tax Act.
- Revitalize the disinvestment program and plan to generate at least Rs. 25,000 crore per year. Complete the process of selling of 5-10 per cent equity in previously identified profit making non-navratnas. List all unlisted public sector enterprises and sell a minimum of 10 per cent of equity to the public. Auction all loss making PSUs that cannot be revived. For those in which net worth is zero, allow negative bidding in the form of debt write-off.
- Introduction of the new Income Tax Code, that results in a neutral corporate tax regime.
- Rationalize Dividend Distribution Tax to ensure full single taxation of returns to capital in the hands of the receiver (i.e. neither double taxation nor zero effective taxation).
- Review and phasing out of surcharges, cesses and transaction taxes (such as commodities transaction tax, securities transaction tax and Fringe Benefit Tax). Incentivise states to do the same with respect to stamp duties.
- Revise specific duties in the textile sector to ensure that they approximate a similar ad valorem rate as originally intended. Reduce these gradually that they do not exceed 30 per cent ad valorem. Convert them to ad valorem rate once WTO negotiations are concluded.
- Review customs duty exemptions and move to a uniform duty structure to eliminate inverted duties.
- Implementation of GST from April 1, 2010 to be done in way to ensure long run fiscal sustainability.
- National ID card based on unique identification number. Rapid operationalization of the UID authority (3 months), issue of UID to all residents (6 months) and creation of an integrated data base of information on all actual and potential beneficiaries of government programmes, subsidies and transfers (one year). A Household ID (HHID) could be created simultaneously or in parallel by linking it to a set of UIDs of individuals constituting the household. These IDs will form the base of a multi-application smart cards (MASC) system that can be used to empower the poor and insure that they get the full benefits of all programmes such as NREGA, PDS, publicly provided education, skill development, health services, social security (to persons at special risk), fertilizer subsidy, solar lanterns, solar cookers, etc.
- Convergence of plan schemes with focus on outcomes. Thrust on quality of expenditure and systems of monitoring and evaluation to improve the productivity of public expenditure.

Figure 2.10: WPI inflation (Y-o-Y) &amp; annualised seasonally adjusted monthly build-up



deseasonalized data, with due caution, can improve inflation forecasts. It is therefore useful to note that deseasonalized data is now clearly indicating that the period of negative WPI inflation will come to an end before the year end.

### Financial markets and intermediation

2.52 The events of 2007-08 and the outflows and inflows of FII equity has brought home with renewed force the volatile nature of certain capital flows. Global capital flows to emerging and developing economies tripled from US\$ 202.8 billion in 2006 to US\$ 617.5 billion in 2007 and then collapsed to US\$ 109.3 billion. India shared in the global boom in private

capital flows to emerging economies with private capital inflows more than doubling from about US\$ 36.7 billion in 2006 to about US\$ 88.8 billion in 2007, them falling back to US\$ 31.2 billion in 2008. Total net capital inflows consequently increased from 4.4 per cent of GDP in 2006 to 9.1 per cent of GDP in 2007 and back to about 3.3 per cent of GDP in 2008. Though the private flows provide critical risk capital with long-term benefits to the economy, the volatile nature of these flows creates a negative externality for the real sectors in the short term. This negative externality can be overcome by internalizing this externality through some form of Pigouvian taxation. An Economic Division working paper (2006) had

#### Box 2.4 : Financial markets – Funds for dynamic entrepreneurs

- Passage of the Banking Regulations (Amendment) Bill, 2005.
- Lift the remaining ban on futures contracts to restore price discovery and price risk-management.
- Bring all financial market regulations under SEBI with a view to encourage integrated development. Broaden the long-term debt market by liberalizing the investment norms of insurance and pension funds and development of credit enhancement institutions. Government can consider a guarantee mechanism (fund) for credit enhancement of long-term infrastructure debt. Tax incentives for long-term debt markets can be considered.
- Liberalize and develop spot and futures currency markets (exchange traded). Raise position limits for domestic companies and allow trading in SDRs and SDR currencies.
- Introduce/allow repos and derivatives in corporate debt.
- Introduce exchange traded interest rate derivatives, such as interest rate swaps (IRS).
- Introduce standardized credit default swaps that can be traded on exchanges, subject to stricter than normal limits on eligible participants.
- Extend spot commodity trading in electronic form to agricultural markets by involving APMCs.
- Auction rights to commercial borrowing within the already defined limits, with in-built (designed) preference for long-term borrowing. Auction of rights to invest in government securities by FIIs (under sub-limit of ECB) has already been successfully carried out.
- High Net Worth Individuals (HNIs) should be allowed to register and invest directly through authorized Indian investment intermediaries. This will allow ban of indirect ways of investment such as P notes.
- Align voting rights in banks with equity holdings. Allow public to hold greater equity in public sector banks within the policy of maintaining social control of management.
- Phased increase in FDI limits in banks and greater entry of foreign banks with tighter regulation of investing foreign banks and other foreign entities.
- Allow trading of directed credit obligations among banks and other financial institutions. This will allow and encourage the development of financial institutions that can specialize in and exploit economies of scale and scope in unbanked/low banked areas and sectors.
- Link small savings rates to government debt instruments or bank deposit rates of similar maturity. Make responsive to deposit-credit market conditions.



suggested that auction of ECB would be one way to reduce the volatility of ECB flows. Since then, a part of ECBs subject to a separate sub-limit, the part destined for the debt market (purchase of government securities and corporate debt) has been successfully auctioned under the supervision of SEBI. This idea can be considered for all forms of volatile cross-border capital flows. There are other issues in financial sector such as those related to the development of long-term debt markets and deepening of corporate debt markets for improving resource flows to infrastructure investments; improving future markets for better price discovery and regulation; encouraging financial inclusion through use of technology; and overcoming institutional hurdles to better intermediation. Some potential policy choice on these issues is reflected in Box 2.4.

### Energy policy

2.53 The boom in oil and other energy prices during 2008 ended in July 2008. Thereafter global prices declined rapidly to around US\$ 40 per barrel. This was expected to be a temporary respite with oil prices likely to rise along with a recovering global economy. Though the time it would take for the recovery to start was very uncertain, it was clear that the respite would be temporary and that this provided a golden opportunity to reform the pricing and control system. It was therefore imperative that petrol and diesel prices be decontrolled so that buyers were aware of the opportunity cost of oil imports and thus contributed their mite to economizing on the use of

refinery products. As long as domestic prices remained below the cost of imports, demand would continue to grow, accentuating the negative impact of the terms of trade effect on national income. In simple words such a situation is a form of foreign taxation of national income, with more tax being paid the more oil/petrol/diesel we consume. As the low prices of oil has provided a temporary window for costless decontrol of petrol and diesel, this window must be utilized at the earliest. Other elements of energy policy, such as open access to power, decontrol of coal also need to be addressed to have a viable and long-term solution to our dependence on foreign oil and the debilitating effect of power failure (Box 2.5).

### Investment environment

2.54 The reforms of the 1990s created a competitive environment in which Indian entrepreneurship could flourish. The fruits of these reforms emerged gradually in the form of rising output and employment and higher growth from 2003-04 onwards. However, there is a perception among financial and other investors that Government has been slow on policy reforms, in the past five years. As long as economic growth was above trend these apprehensions did not matter, but an economy where the industrial (manufacturing) growth has been steadily declining for nearly eight quarters over 2007-08 and 2008-09 with the revival still uncertain, policy interventions are necessary. More so the sector has been one of the main drivers of the recent spurt in

#### Box 2.5 : Energy dependence or independence

- Decontrol petrol and diesel prices. Develop a policy response system and financial buffer for use when diesel prices rise above the oil equivalent price of US\$ 80 a barrel (in 2008 prices).
- Competition from organized private bus companies (free entry on a level playing field with small operators and SRTCs) can increase fuel efficiency of public transport through modern planning and maintenance systems; Indirect taxes on buses can be eliminated to promote public transport.
- RGVY and other energy programmes should focus on go-bar gas and solar energy in hilly or distant regions of the country and other areas where lack of electricity makes extension of grid futile.
- Private entry into coal mining under a well regulated and competitive coal sector to help reverse the substitution of domestic coal by imported oil and coal. Coal de-nationalization act would need to be amended to allow this on the lines of Coal Mines Nationalization (Amendment) Bill, 2000.
- The two sick subsidiaries of CIL, namely ECL and BCCL should be listed, 49 per cent shares sold to public and management control transferred to a private party (perhaps through an auction of 26 per cent of shares plus management control package).
- Sell old oil fields to private sector for application of improved/enhanced oil recovery techniques.
- A competitive electricity production market that pays the full global cost of fuel will help eliminate inefficiencies in the current monopolistic state electricity supply system. Open access must be expeditiously operationalized by each State Electricity Regulatory Authority (ERA) notifying a rational/reasonable cross-subsidy. With a competitive electricity sector the increasing trend in use of diesel Gen sets could be reversed.
- The Atomic Energy Act needs to be amended to permit private corporate investment in nuclear power, subject to regulation by AERB and AEC. Frame the rules for private and foreign entry (49 per cent FDI).

**Box 2.6 : Improving the investment environment, driving growth**

- Passage of the Pension Fund Regulatory and Development Authority Bill, 2005; Forward Contracts (Regulation) Amendment Bill, 2006 and the Insurance Laws (Amendment) Bill, 2006.
- Raise foreign equity share in insurance to 49 per cent. In addition, consider allowing 100 per cent foreign equity in a special category of insurance companies that provide all types of insurance (e.g. health, weather) to rural residents and for all agricultural related activities including agro-processing. This may help dispel fears of foreign equity in insurance.
- FDI in multi-format retail, starting with food retailing. Initially this could be subject to setting up a modern logistics system, perhaps jointly with other organized retailers. A condition could also be put that it must have (for 5 years say) wholesale outlets where small, unorganized retailers can also purchase items (to facilitate transition).
- Raise FDI limit in defence industries to 49 per cent (from 26 per cent); allow up to 100 per cent FDI on a case by case basis, in high technology, strategic defence goods, services and systems that can help eliminate import dependence.
- Decontrol sugar and fertilizer industry, simultaneously converting any producer subsidies into direct consumer subsidies.
- Drug price control should be limited to essential drugs in which there are less than five producers. All others should be decontrolled.
- Create an Internet enabled data/information system(s) to help MSMEs market their goods and services across India and the world.
- Set up an independent environment professional regulator with complete autonomy and accountability for implementing environmental regulations. The ministry should be concerned only with environment policy. Real estate and housing developments should be outside the purview of Central environmental regulations and left to states.
- Set up a single regulatory body for the transport sector, covering highways, railways, ports and airports, with at least one member from each subsector. If needed the authority could also have specialized groups of professionals in each sector. The corresponding department/ministry could be the authority for appointing the subsector member and the specialized subunits. The chairman of the body would also be assisted by a neutral economic unit. The Planning Commission could act as the nodal body for carrying out the selection procedure for the chairman and for staffing the economic unit.
- Broadband-Internet connectivity: Allow open access to local loop for broadband provision and designate the cross-country/rural fibre-optic network as a "public carrier" for provision of telecom connectivity in rural areas. Eliminate revenue share and other telecom charges on provision of broadband connectivity to villages.
- Disaggregate telecom licences from spectrum allocation. Telecom licence should have a nominal regulatory charge and be based on capability to provide sustained service. Spectrum should be auctioned and be freely tradable among companies having a telecom licence. The auction price can be in the form of a fixed price or charge per unit of bandwidth per annum or a combination of the two.
- Private entry into provision of passenger train/railway services should be allowed to and from all tourist destinations. About a dozen tourist routes could be identified and a single licence issued to private companies to provide passenger services on any/all these routes.
- Corporatization of departmental enterprises providing commercial services. Convert port trusts (minus excess land) into publicly listed companies with at least 49 per cent of shares held by the general public.
- New bankruptcy law to ensure speedy and effective bankruptcy so as to save/preserve assets for alternative use.

GDP growth. Box 2.6 outlines some the reforms that could be considered for implementation in the coming months.

2.55 Another aspect that is worth noting is the emergence of a large gap between wholesale (WPI) and consumer (CPIs) inflation rates. It suggests that the supply chain is unable to cope with accelerating growth in income and consumer demand. This points to the urgency of reforming the land market and real estate sector, retailing, public transport and food supply chain, with a view to promoting modernization and competition.

### Governance, public goods and institutional reforms

2.56 It has been variously argued that the government at the cutting-edge level, where it

interfaces with individuals and economic agents, is the most important constraint on raising and sustaining the growth rate of the economy. As substantial resources, both public and private, are being mobilized to fuel the growth of the economy and make it more inclusive in character, there is a legitimate concern that every bit of the public effort should count and yield better results. There is a need to strengthen the accountability mechanisms in the public domain and give them teeth. The enactment of the Right to Information Act at the Centre and in many states has bridged a critical gap in the public decision-making process, ushering in greater accountability of the public servants. This move towards greater transparency and right to access public information has been greatly aided by developments in information technology and e-governance. Benefits from these developments need to be extended to other areas.

2.57 With a view to improve transparency in distribution of funds and prevent leakages, an Internet-based public accountability (PAIS) system should be set up to provide information to the targeted population about (i) the expenditure allocated and spent, the receivers of the expenditure, (ii) the major programme inputs purchased (sources, amounts) the people hired and their actual attendance record (e.g. teachers), (iii) the output of the programme and when available its quality. These would be put on the website accessible through the Internet. To empower the target beneficiaries (users) to put up their own evaluation of the programme alongside the government provided data and information. A PAIS system should be designed for the police and courts and introduced on an experimental basis in Delhi and other Union Territories. PAIS systems could also be designed for local roads, sewage and sanitation, drinking water supply and tested in the Union Territories. In states PAIS would be a geographically multi-level, multi-layered system in which higher levels would present data after aggregation/integration from lower levels/layers.

2.58 There is also a need to strengthen the project monitoring and evaluation system for public programmes and linking the performance and

feedback with subsequent allocations of resources and continuation of programmes (Box 2.7).

### *Hunger, malnutrition and poverty*

2.59 The notion of hunger, malnutrition and poverty though related are distinct in nature, both conceptually and in terms of policies required to address them. While hunger refers to inadequacy of food, malnutrition refers to an imbalance of both macro and micro-nutrients, which could be because of inadequate or inappropriate intake and/or inefficient biological utilization due to physiological or environmental factors. The notion of poverty in India for estimating the incidence of poverty involves the use of a minimum consumption expenditure, anchored in an average (food) energy adequacy norm of 2,400 and 2,100 kilo calories per capita per day. At the all-India level 1.9 per cent of the household suffer from hunger (NSSO data) and it is more prevalent in certain states like West Bengal, Orissa Assam and Bihar. Malnutrition, as measured by underweight children below three years, is estimated at 45.9 per cent as per National Family Health Survey 2005-06. The comparable estimates for 1998-99 at 47 per cent show a relatively stable incidence of malnutrition. The incidence of poverty at the all-India

### Box 2.7 : Public goods and institutional reforms

- Integrated urban development policy and radical reform of urban governance.
- Amended land acquisition and rehabilitations laws to ensure equity between land owners (including farmers), land users and developers.
- Streamline rules, procedures and process of conversion of land from rural or semi-rural to well planned urban communities (network of roads, water, sewerage, drains, underground conduits for public utilities and public transport).
- Develop a model (or models) of land use policy that is responsive to local conditions and environment, fair to existing land owners and accelerate the development and transformation of urban land to most productive use.
- Change urban land use rules to separate land use for hotels from commercial land use and define transparent rules for setting up of hotels in mixed use locations and the borders between commercial and residential areas (subject to provision of internal parking and adequate size roads for access).
- Review and radical transformation of urban public transport policy and system. Open to organized private companies that use modern logistic and back office systems for planning routes and timings, acquiring and analyzing data on usage densities and running an integrated people movement system. A comprehensive system of road parking fees must be devised and implemented in large congested cities and metros.
- Allow use of degraded forest land for growth of tree crops for paper industry.
- Notify of the Delhi Rent Control Act long passed and approved by the President.
- Develop model Land Lease Act for use of states.
- National Waste Mission: With rising prosperity the country and its people will be swamped by mountains of solid waste and sewerage. We need to set up a national sewerage grid and a national solid waste collection and disposal system to complement a national clean water grid. This is a multi-level (states, districts, nagarpalikas and panchayats) and multi-component (collection systems, transport, processing, disposal) that will also require planning, training and building of professional bodies.
- Police Reform: Implement the Supreme Court decision/ directive on police reform.
- Legal Reform: Reform antediluvian procedures to eliminate delays and scope for creation of obstacles to speedy completion of trials. Carry out a systematic review of all old laws with a view to elimination or replacement by modern laws.
- Courts and Judges: Fill vacancies, provide comprehensive IT and other database services and modernize management of courts, cases and judgements.

**Box 2.8 : Education and Employment generation**

- Reform the regulatory framework and regulatory institutions for higher education, to focus on providing honest and transparent quality rating and information on financial costs. Allow regulated entry of high quality foreign and rated domestic institutions to provide higher education.
- Targeted and outcome oriented review and reform of elementary education, public health institutions and curative health infrastructure; Empower the poor and weaker sections through government funded smart card based payments to public sector providers of education and health. Set up rating system for providers of social services (education, health, social welfare), covering public sector, non-profits and NGOs and private sector.
- Set up a sophisticated, IT-based, employment information system for unskilled, semi-skilled and skilled labour, that can reflect demand and supply across the rural-urban divide, across education-income categories and across different states. The PPP mode can be used to ensure that both public and private good elements are accounted for.
- In water scarce areas (e.g. drylands and red groundwater areas with low and declining water levels) introduce free/low cost water entitlements for farmers using smart cards, vouchers or bank accounts and allow rest to be priced and traded. This will ensure efficient use of scarce water resources and payment by commercial users.
- Employee State Insurance (ESI): Review the system of administrative charges (3 per cent), penalties and interest (17 per cent) for delayed payments, which appear to be quite onerous for SMEs, particularly given their credit constraints.
- Retrenchment of workers: At present prior permission of Government as per Chapter V-B of Industrial Dispute Act is needed for this purpose. This needs to be removed with simultaneous increase in compensation from the present 15 days wages for every year of service.
- Contract Law needs to be amended to allow use of contract labour in non-core activities or when the activity is of intermittent nature during the year. Labour laws should be applicable to the contract labour providing company that pays their wages. Returns should be simplified.
- Factories Act needs to be amended to increase workweek to 60 hours (from 48 hours) and daily limit to 12 hours to meet seasonal demand through overtime.

level in 2004-05 was estimated at 27.5 per cent. There is often a tendency to use these concepts loosely, which is not only incorrect, but it also does not help in creating the right focus for policy redress (Figure 2.11, and Chapter 10, Table 10.4 for more details).

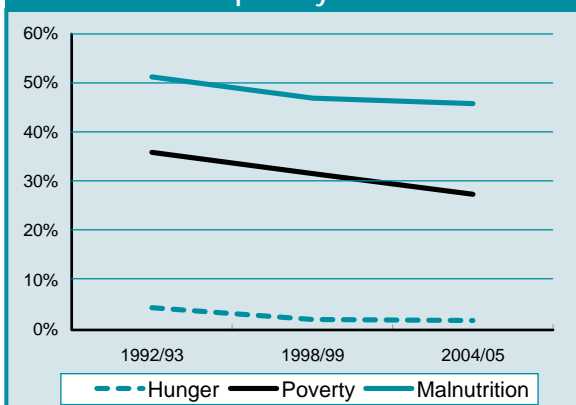
2.60 It is indeed a matter of concern that despite the country having attained self-sufficiency in food production for nearly three decades, and with

mounting public food stocks at its command, that there is still hunger in the country and that malnutrition is so widespread. It is time that the various interventions, at the state and at the Central level addressing these issues are reviewed and redesigned, if required, to address these social concerns in a time-bound manner.

**SUMMING-UP**

2.61 The economy grew at an average rate of 8.8 per cent during the five-year period from 2003-04 to 2007-08. The growth rate fell by 2.1 per cent points to 6.7 per cent in 2008-09. While noting with satisfaction the move of the economy to a higher growth path, the Economic Survey of 2007-08 had also underscored the difficulties involved in maintaining high growth. It had warned that while globalization provided new opportunities, it also gave rise to new challenges. A balanced perspective suggests that neither should one rest on the past laurels nor should the present setback weaken the determination to return the economy to the high growth path at the earliest. High growth is critical to generate the revenues needed for meeting our social welfare objectives on a sustained basis and ensuring inclusive growth.

**Figure 2.11 : Incidence of hunger, malnutrition and poverty**



**Note :** Hunger estimates from NSS data, poverty estimates from Planning Commission (interpolated for 1998-99) and malnutrition estimates from NFHS I, II, III. The data for the three variables corresponds to the year closest to the indicated years.