Mid-Year Review of the Indian Economy 2008-2009

Nagesh Kumar

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Challenges of Sustaining Dynamism in the Context of Global Financial Crisis

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Preface

This year the India International Centre's mid-year review could not be published in time for the national budget, as is normally the tradition, but it comes out at a time when the assessments and forecasts made by the eminent speaker, Dr. Nagesh Kumar, Director-General of the Research and Information System for Developing Countries (RIS), have to be seen in the context of a changed political reality post-elections in India. The review will be eagerly read by those who keenly watch the economy and anticipate growth pursuant to the anticipated implementation of much-needed economic reforms in India. Last November when the review was delivered to a packed hall, the world was in the midst of a most serious economic crisis, and the Indian economy could not remain unaffected by the deteriorating external economic environment. The speaker had argued in his presentation that the time had come for taking bold steps to revive the growth momentum. In spelling out some of these steps during his presentation the speaker had, even while making a mid-year assessment, gone beyond the projections of the previous Indian budget to analyse the long-term trends in the macroeconomic performance of the Indian economy, the outlook, and the policy responses required to meet the challenges. In the changed political environment of today, these assessments will be keenly scrutinized by the readers of this volume.

The Centre is grateful to Dr. Nagesh Kumar for his insightful study, to the two Discussants, Professor Pinaki Chakraborty of National Institute of Public Finance and Policy, New Delhi, and Mr. M. K. Venu, editor of the Edit Page of *The Economic Times*, New Delhi, for their stimulating comments, and to the Chairperson, Prof. Shankar N. Acharya of ICRIER, for his able steering of the seminar proceedings.

It is warming to find that the Malcolm and Elizabeth Adiseshiah Trust (MEAT), Chennai, has not only been supporting this initiative at the Centre for some years now but has also shown a keen interest in the publication that comes out of the seminar proceedings. The Centre thanks the MEAT and looks forward to a continuing collaboration. The publisher, Mr. D. Kumar, is to be thanked for his sustained interest in bringing out this publication. Finally, all the participants—economists, academics, special correspondents, researchers—are thanked for continuing to attend the seminar each year, participating in it actively and keenly, thereby making it a meaningful activity at the Centre.

Bela Butalia
Editor

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The author has benefited from helpful discussions with Dr. Ram Agarwala, Distinguished Fellow, RIS, and comments of Dr. Shankar Acharya (ICRIER), Mr. M.K. Venu (*The Economic Times*), Dr. Pinaki Chakraborty (NIPFP), and participants of the IIC seminar. He would also like to thank Dr. Prabir De (RIS), Dr. I.N. Mukherji (RIS) and Dr. K. Bhanumurthy (Institute of Economic Growth) for their useful inputs. Research assistance of Sayan Samanta (RIS) is acknowledged. Neither RIS nor IIC are responsible for the views presented or any errors that remain.

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1

Introduction

This year's mid-year review of the Indian economy is undertaken against the backdrop of the most serious financial crisis the world economy has faced since the Great Depression of the 1930s. In an interdependent world economy, economic prospects of no country can remain unaffected by a crisis of the magnitude of the current one. The Indian economy is no exception and has also been affected adversely in a number of ways, as we will see later. The Review will also discuss different challenges that the country faces in the context of deteriorating global economic environment and concludes with a policy agenda for addressing them.

The structure of the Review is as follows. Section 2 briefly summarizes the external economic environment which is constantly deteriorating since August 2007 and its impact on the growth outlook worldwide. It also discusses the causes of the crisis which points a finger at the continued profligacy of the US economy fostered by the government over the past 7-8 years to be the root cause of the crisis.

Section 3 summarizes the long-term trends in the macroeconomic performance of the Indian economy and the outlook for 2008/09 and beyond. The Indian economy has over the past five years moved on to a new, higher growth trajectory with average annual growth rates closer to 9 per cent. This turn around has been accompanied by greater resilience of the Indian economy to external shocks despite growing international economic integration. Against that background, we examine the outlook for 2008/09 and beyond for the broad sectors as well as for the Indian economy as a whole.

Section 4 discusses the important issue of quality of growth in terms of social inclusion. The evidence tends to suggest that income inequalities between the states and within the states have widened over the post-reform period. Therefore, the recent growth spurt has been of an inferior quality from the equity perspective. Development of physical and social infrastructure emerges as an important factor contributing to equitable growth. The infrastructure development also is found to have important effect on poverty reduction. Furthermore, the role of public investment in driving infrastructure development is emphasized.

Section 5 takes a look at the performance of the Indian economy in terms of prices and fiscal balances. It would appear that the high inflation during the first half of 2008/09 was largely imported. Hence, the tight money policies unleashed by the RBI may not have been effective in controlling the prices but did adversely affect the growth momentum. It also highlights that although fiscal consolidation has been achieved, to some extent it has been done at the expense of development expenditure and hence may have compromised the long-term sustainability of growth. It also questions the over-emphasis on the targets of fiscal balance that may be relevant for the matured economies but may not be relevant in expanding economies like India's in view of the critical role of public investment in driving the growth process.

Section 6 looks into the trade and balance of payments related issues. The performance in terms of trade presents a mixed picture. While geographical diversification in terms of markets and sources has taken place successfully, we have failed to upgrade the technology profile of India's exports in favour of high value adding goods. It shows that after a number of years of rather comfortable balance of payment situation, India was entering a period of stress which needs to be paid attention to.

Section 7 deals with capital flows and their quality in terms of developmental impact. In the past few years India's reliance on foreign institutional investors (FIIs) has increased. The FII inflows are shown to be highly volatile, and expensive in terms

of servicing burden besides their effect on the exchange rates and stock market indices. FDI inflows have begun to rise with the recent improvement in the investment climate. However, we need to improve the quality of FDI inflows so that the country can exploit the potential of FDI in developing export-oriented industries which create output, jobs and foreign exchange and also crowd-in more domestic investments rather than substitute it.

Finally, Section 8 summarizes the policy lessons to moderate the impact of crisis on Indian economy and to turn the challenges into opportunities. The policy lessons include, in terms of size and focus of fiscal stimulus packages, steps needed to address the emerging bop challenges, the trade policy priorities and those for the reform of the financial architecture.

2

Deteriorating External Economic Environment

After five years of a rather benign external economic environment, 2008/09 has turned into a very dramatically adverse situation for the Indian economy as for most others. In the first half of the year the economy faced a crisis because of oil prices peaking at US$ 140 a barrel, the international prices of other commodities especially food and metals also going up and the inflationary conditions that developed. That inflation, even though imported, led RBI to follow tight money policies which had already caused some slow down in the growth momentum.

In the second half the Indian economy started facing the real brunt of the US financial crisis which is turning into a full-scale global crisis. It involved collapse of the financial system in the Western world with very widespread bankruptcies led by some of the towering icons of investment banking on Wall Street such as Lehman Brothers or Bear Stearns. The five top investment banks on Wall street do not exist any more in the same form that they used to. The losses in the financial sector run into trillions of dollars and the US has recently announced a 700 billion dollar bailout package but that is not enough and trillions of dollars are needed. The roots of the crisis can be traced to the US profligacy and lax regulations of financial sector (see Box 1).

The meltdown of the financial sector in the West has left emerging markets in very difficult situations. The emerging economies had attracted a lot of investments from foreign institutional investors (FIIs) over the past five years because of their booming stock markets. With the liquidity crisis in the US,

FIIs started to suddenly pull out and in that process created a lot of pressure on the stock markets in these emerging economies and on their currencies. The currencies of most of the emerging market economies came down and the stock markets have crumbled. Now it is hurting the real economy as well.

Box 1: Roots of the US Financial Crisis

The US financial crisis of 2007/08 has been described as the largest financial shock since the Great Depression" by IMF (2008:4). It is important to identify the factors that have led to this crisis. Some analysis is now available that points to the US profligacy to be the root cause of the crisis.

In the context of dotcom crash of the 2001, the ghastly events of 9/11, stock market gloom following a series of corporate scandals, such as those involving Enron and WorldCom, there was an urgent need to stimulate the economy and avoid deep recession. The macro-economic managers in the US launched an expansionary programme with drastic reductions in interest rates and loosening of credit norms. Housing market as well as consumer credit market expanded rapidly with official blessings. Lured by the prospect of rapidly rising prices of houses and encouraged by the availability of cheap mortgages, households expanded their purchase of houses often well beyond their needs (to cash in speculative gains) or affordability. In an enthusiasm for innovative packaging, the financial institutions were leading the programmes for securitization of mortgages in a manner that did not make their risks transparent. With high leverages, hedge funds and other agencies extended loans to households, municipalities and businesses well beyond the calls of prudent risk management and the managers walked away with handsome bonuses running in hundred of millions of dollars. With the exception of a few voices there was a conspiracy of silence about the overextension of the financial risks and inflated rewards for the participants in this bubble. Soon there was expansion of government expenditure due to military operations in Afghanistan and Iraq.

US savings both household as well as government, plummeted with the country running into huge current account deficits. In a normal economy, this would have led to depreciation of exchange rate and provided a check to excess consumption. But with the reserve currency status of the US

(*Continued*)

(*Box 1 continued*)

dollar, the country could finance these deficits simply by printing money—'deficit financing' at the global level. Between 2001 and 2007, the US had current account deficits of US$ 4.31 trillion. Such deficit financing should have led to global inflationary pressures but the recipients of US$ had high liquidity preference for the US currency and they chose to hold most of their surpluses in US Treasuries rather than spend them on goods and services. The managers of the financial system in the US were lulled into complacency by their belief in the self-healing power of the markets and by their assumptions about exeptionalism of the US in its ability to sustain large current account deficits over a long period.

There was calm in the world economy even though the indebtedness of US household sector and government sector was increasing dramatically to an unsustainable level.

As it has happened repeatedly around the world, what is unsustainable will not be sustained. The cracks in the household debt management began to appear in August 2007 when with rise in interest rates, some households which had borrowed for houses beyond their affordability began failing to meet their mortgage obligations. With the new rules on transparency and valuation of capital of the financial institutions, major financial institutions were faced with inadequate capital and with risks of bankruptcies. Within an interconnected financial system these losses began to snowball and there were systematic risks to the financial system in the US. Afraid of repeating the scenario of the Great Depression, the authorities followed a policy of rescue operation and stimulus (in a wise departure from the contractionary policies followed during the Asian financial crisis of 1997/98). The interest rates were slashed by 300 basis points within 28 weeks, a fiscal stimulus package of $170 billion was announced with bipartisan support. The Federal Reserve even took an extraordinary step of helping in purchase of an investment house on the brink of bankruptcy. With all these efforts, an apparent calm has been restored. However, the losses of the financial system are massive and increasing rapidly as the defaults spread to consumer credit and municipal and corporate bonds. According to IMF, "potential losses to banks from exposure to the U.S. subprime mortgage market and from related structured securities, as well as losses on other U.S. credit classes such as consumer and corporate loans, could be on the order of $440-$510 billion, out of total potential losses of $945 billion" (*WEO* 2008b:7). (*Continued*)

(*Box 1 continued*)

On the household side the trauma of foreclosures will have serious dampening effect on their demand. With the projected decline in house prices of 10-20 per cent in 2008 alone, the decline in household wealth in housing will run into trillions of dollars and could have a serious adverse effect on household consumption. Combined with declines in equity prices and increasing unemployment, the household consumption, the biggest component of aggregate demand is set to take a beating. As the financial sector achieves some stability the real sector may start its downward drift.

Former Federal Reserve chairman Paul Volcker has characterized the current US financial crisis the 'mother of all crises' and has gone on to say: 'the bright new financial system, with all its talented participants, with all its rich rewards, has failed the test of the market place'. When asked about the possibility of a dollar crisis, Mr. Volcker retorted, 'Dollar crisis ... you don't have to predict it, you're in it'. He also said that a propensity to consume more than it produces is what got the United States into this sort of trouble. 'Financial crises usually don't come along unless there are other underlying problems in the economy. You can't go on forever spending more than you're producing. You have to rely on unorthodox finance to sustain it.'

Source: RIS (2008)

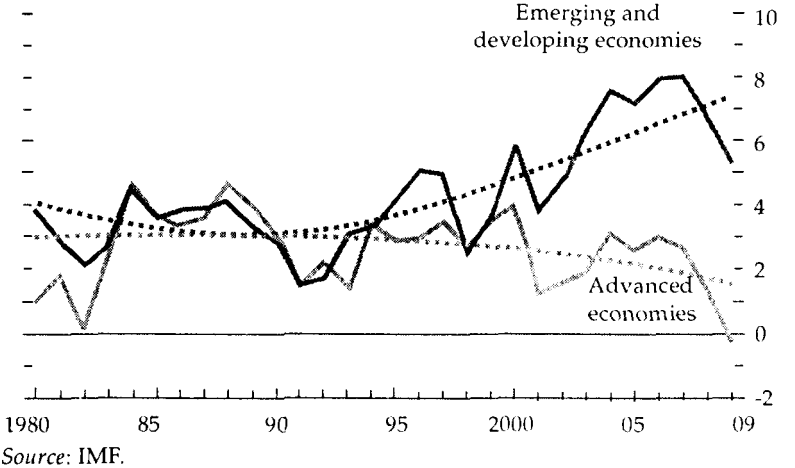
Policy responses in the western world have varied, comprising nationalisation of distressed institutions, providing public funds to bail out and recapitalise banks, sometimes providing comprehensive guarantees as in Europe, reduction in policy rates to ease the liquidity and also announcements of fiscal stimulus packages for reviving demand. Most recently China has come up with a US$ 586 billion stimulus package. But all these trends in the world economy put a developing economy or an emerging economy like India in a very difficult situation and cause a huge adjustment burden.

The most authoritative source for the outlook for the world economy is the IMF's *World Economic Outlook*. In the *WEO Update* issued on 6 November 2008, IMF (2009) expects that in the Q4, the last quarter of the calendar year of 2008, the G3 economies, that is US, EU and Japan, will be nearly flat with

only 0.3 per cent growth rate. In 2009 they will be shrinking by -0.3 per cent. So we cannot expect any growth stimulus whatsoever for the next year to come from G3 economies as the locomotives of yesterday's world economy will be shrinking rather than providing any growth stimulus to any country. However, IMF finds that emerging economies will still be growing even though at slower rates, viz. at 6.6 per cent in 2008 and 5.1 per cent in 2009 (Figure 1). On the back of the existing robust growth of emerging economies, the world output is likely to grow at 3.7 per cent in 2008 and 2.2 per cent in 2009 which is a slowdown compared to 5 per cent achieved in 2007, nevertheless healthy considering that the G3 economies will be actually shrinking. For obvious reasons, the IMF would like to be cautious and may be underplaying the extent of shrinking of the G-3 economies. We have to be prepared for a much more dramatic shrinkage of the advanced economies.

Figure 1: Real GDP Growth and Trend

(Per cent change)



Source: IMF.

Subsequent to the presentation of the present Mid-Year Review, the IMF revised the growth outlook downwards in its January 2009 update. IMF now expects the G-3 economies to

shrink by -2.0 per cent in 2009. The emerging and developing economies were expected to grow at 3.3 per cent and world economy at barely 0.5 per cent!

Figure 1 also highlights the phenomenon of decoupling or the diverging growth profile of emerging and advanced economies especially in the current decade. In the current scenario of gloom in the Western world if the emerging economies are still able to pull a 5-6 per cent growth, this also indicates a bit of a decoupling. But given the integration of financial markets, there is a deeper coupling between advanced and emerging markets in the financial sector. So what one finds is that while real economies are decoupling, their financial sectors have become even more tightly integrated with each other.

3

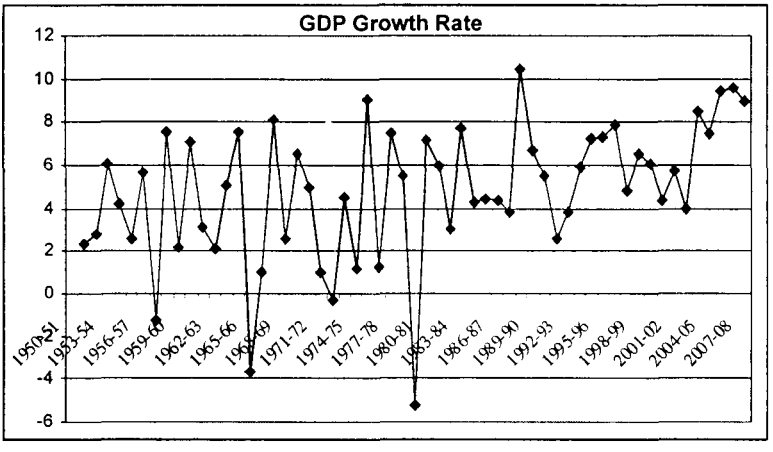
Long Term Trends in the Macroeconomic Performance of the Indian Economy: Outlook for 2008/09 and Beyond

Before discussing the outlook for the Indian economy in the current year and beyond, a word on the long-term trends in the Indian economy would be in order to serve as a *background. We have seen a progressive acceleration of* India's economy or GDP growth, moving up from 3.5 per cent in the first three decades of its independence (Figure 2), to 5.7 or 5.8 per cent in the next two decades, nearly up to 2003. From 2003 India embarked on a new growth trajectory with an average of 8.8 per cent in 2003-2008 but 9.3 per cent during 2005-08. Another aspect of India's recent growth performance has been that volatility of growth has come down substantially from pre-1980s period (Kelkar 2004). The Indian economy has developed a remarkable resilience to external and internal shocks as has been demonstrated over the past decade when it survived the effects of the East Asian crisis, slow down of the world economy towards the end of the 1990s, and the oil price shocks without much disruption. The Indian economy weathered the 1997 crisis in the East Asian economies, then the dotcom bust of 2000 and now even in this crisis we hope it will come out of it without too much of a problem.

While analysts have attributed the recent surge in India's growth rate to a number of factors such as reforms and opening of the economy, improved productivity, strong foreign inflows (see Ahluwalia 2008; Mohan 2008b; Panagariya 2008; Rodrik and Subramanian 2004b; among

others), a major factor contributing to the growth acceleration has been the increasing savings and investment rates especially since 2002 (see Figure 2a).

Figure 2: Growth Rate of Indian Economy, 1950-2008



Source: RIS based on Ministry of Finance data.

There has been a consistent improvement in government savings as a result of fiscal reforms while corporate saving rates have improved due to reduction in corporate tax rates as well as declining interest rates (Mohan 2008a). The efficient financial intermediation also assisted in translating these savings into capital formation (see Box 2). India's savings performance has been consistently better than that of other developing countries with comparable per capita income (Loayza and Shankar, 2000). Figure 2a also shows that the investment rate remained closely linked to the domestic savings rate rather than to foreign savings despite the reforms and liberalization undertaken since 1991. To raise adequate resources for development, the Indian government had put the ambitious target of an 8 per cent increase in savings rate in the Tenth Five Year Plan (2002-2007) which seems to have been more or less achieved.

Box 2: Explaining India's Growth Record: Sustained Savings and Investments

India has been maintaining real GDP growth averaging around 9 per cent per annum over the four-year period ended in 2006-07; the average for the last two years has been 9.5 per cent per annum. Except 1970s, there has been a secular uptrend in real GDP growth largely enabled by consistent trends of increasing domestic savings. Further, the recent acceleration in growth has been facilitated by a surge in private investment and corporate growth. The gross domestic savings have increased continuously from an average of 9.6 per cent during 1950s to 35 per cent of GDP at present; over the same period, the domestic investment rate has also increased continuously from 10.8 per cent in 1950s to close to 36 per cent in 2006-07. Moreover, the improvement in public finances and public sector savings has contributed significantly to the step-up in domestic savings and investment rates since 2002-03 onwards. Higher savings and investment rates, in turn, have led to a higher growth trajectory of the Indian economy. Indian economic growth has been predominantly financed by domestic savings while recourse to foreign savings (current account deficits) has been very modest throughout. Public sector savings continued to deteriorate during 1990s even turned negative over the five-year period 1998-2003 owing to sharp deterioration in savings of the government administration. This phase of fiscal imbalance was largely the outcome of the fiscal consolidation brought after 1996-97 through compression of capital expenditures from 5.6 per cent of GDP in 1990-91 to 3.1 per cent in 1996-97 with consequential effects on growth and infrastructure constraints. Capital outlays continued to bear the burden of fiscal adjustment with the ratio of capital outlays to GDP reaching their lowest levels during the period 1997-98 to 2002-03, both at the central and state levels. Reflecting the worsening of the fiscal situation, the public sector savings rate deteriorated in the second half of the 1990s, culminating in unprecedented dissavings during the period 1998-99 to 2002-03. With overall reduction in aggregate saving and investment rates, the household financial savings rate (around 10 per cent) and the private corporate sector savings rate

(continued)

(*Box 2 continued*)

(around 4 per cent) stagnated during this period at the mid-1990s levels. Consequently, the investment rate also came down from the peak of about 26 per cent in 1995-96 to 23 per cent in 2001-02 with real GDP decelerating to 3.8 per cent in 2002-03. However, since 2002-03 there has been tremendous improvement in overall macroeconomic management through Fiscal Responsibility and Budget Management (FRBM) Act, 2003 at the centre and similar legislations at state levels (rule-based fiscal policy) resulting in significant gains in the fiscal consolidation process. As a result of the overall improvement in fiscal consolidation, e.g. expenditure reprioritization, increase in tax revenue, quantitative and qualitative improvements in key deficit indicators, the dissavings of the government administration declined from (-) 6.0 per cent of GDP in 2001-02 to (-) 1.3 per cent in 2006-07. Since 2003-04 onwards, total public savings have turned positive again. The saving rate of the overall public sector improved from (-) 2.0 per cent of GDP in 2001-02 to 3.2 per cent of GDP in 2006-07 enhancing domestic savings from 23.5 per cent to 34.8 per cent over the same period. The savings of the non-departmental undertakings exhibited steady improvement since the 1970s, and continued during the reform period. Following rise in savings rate, the public sector investment rate also increased from 6.9 per cent of GDP in 2001-02 to 7.8 per cent in 2006-07, but this level is still significantly lower compared to 1970s, 1980s and early 1990s. Despite this increase, public sector's saving-investment gap has narrowed down from 8.9 per cent of GDP to 4.5 per cent during 2001-07.

The private sector savings, constituting a major segment of domestic savings, witnessed substantial improvements. Particularly, steady reduction in corporate tax rates, reduction in peak rates of custom duty on non-agricultural goods, moderation in nominal interest rates and substantial reduction in debt servicing costs correcting the corporate balance sheets in terms of rise in profit-after tax, decline in ratio of interest expenditure to sales revenues and progressive increase in retained profits contributed to this phase of corporate revival. All these led to doubling of the private corporate sector saving rate from 3.4 per cent in 2001-02 to 7.8 per cent in 2006-07. The evolution of the savings rate follows a linear trend; around 1 per cent in 1950s; 1.7 per cent

(*continued*)

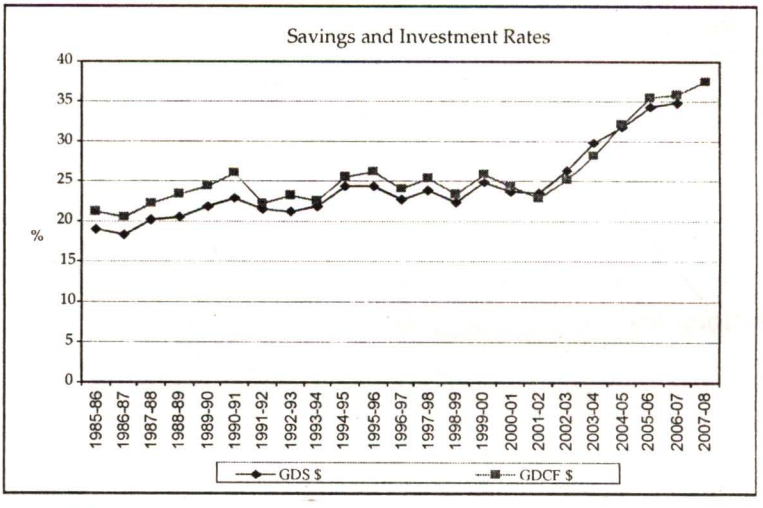
(*Box 2 continued*)

in 1980s, 3.8 per cent in 1990s, to almost 8 per cent now. Corporate investments also followed suit. Both public and private investment started increasing after 2003-04 leading to a virtuous cycle of crowd-in enabled by rise in public investment reversing the 1980s trend of crowd-out. Lower financing requirement of the government and increased access to the domestic and international capital markets led to sharp increase in investment rate of the corporate sector from 5.4 per cent of GDP in 2001-02 to 14.5 per cent in 2006-07. Gross financial savings grew from 13.8 per cent in 2004-05 to 18.3 per cent in 2006-07.

However, the saving-investment gap of the corporate sector widened from 2.1 per cent of GDP in 2001 to 6.8 per cent in 2006-07. The widening of the S-I gaps of the public and private corporate sectors combined was partly financed from household financial savings and partly by foreign savings. These stylized facts reflect the strengthening of the reforms process targeted at overall improvements in fiscal situation through rationalization of direct tax rates and broadening of tax base, and expenditure reprioritization, financial sector reforms—reduction in SLR and CRR rates, abandonment of monetization of fiscal deficits, banking sector reforms, and sustained rise in trade and capital inflows. The increase in financial deepening in recent years and the attainment of overall efficiency in use of resources suggest that financial intermediation in India has been relatively efficient. Since domestic savings will continue to be the source of investment and growth in coming years, a greater emphasis on stepping up public investment and containment of subsidies, while adhering to fiscal consolidation, is likely to pay rich dividends. As per the Working Group on savings for the Eleventh Five-Year Plan (2007-08 to 2011-12), sustaining a real GDP growth in the range of 8-9 per cent would require the investment rate to accelerate to 36-38 per cent of GDP and gross domestic savings rate to a range of 34-35 per cent of GDP based on the then prevailing savings rate of 29.1 per cent and investment rate of 30.1 per cent for 2004-05.

Source: Excerpted from Mohan, Rakesh (2008a).

Figure 2a: Savings and Investment Rates in India



Source: RIS

The other factor underpinning recent acceleration in growth has been the ability of the Indian economy to structurally transform itself from an agrarian economy in favour of the industrial and services sectors (Table 1). The services sector has emerged as an important growth driver with 55 per cent share of GDP in 2006 with services contributing the bulk of output growth since 1990 (Table 2).

Table 1: Sectoral Composition of Production, 1991-2006

(as per cent of GDP)

Sector	Agriculture		Industry		Services	
	1991	2006	1991	2006	1991	2006
Share in India's GDP	28.4	18.0	23.8	28.0	38.0	55.0

Sources: RIS based on WDI CD-ROM, 2007; WDI, 2008 (print version); *UNCTAD Handbook of Statistics 2006-07*.

Table 2: Contribution of Different Sectors to Output Growth

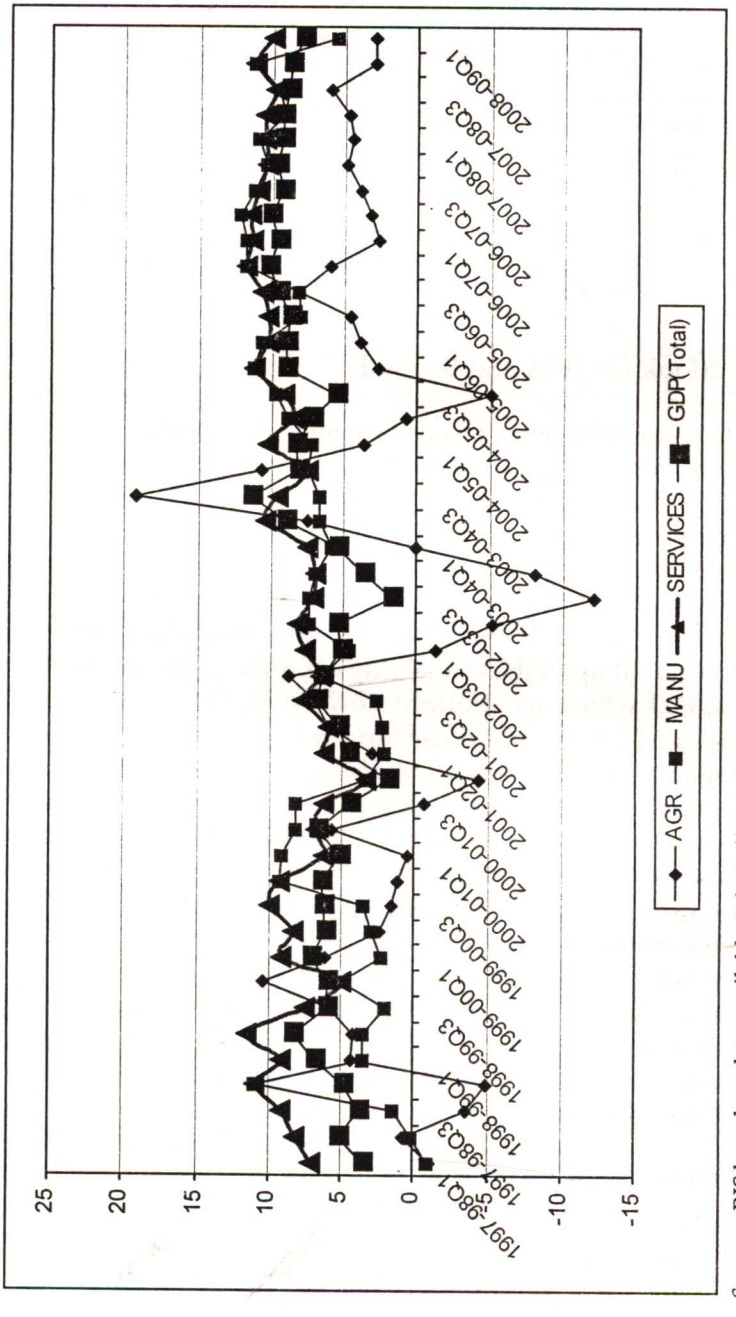
Year ↓	Agriculture	Industry	Services
1985-90	17.2	29.1	43.8
1990-95	20.0	23.9	52.4
1995-02	13.2	20.4	61.7
2002-05	11.3	24.7	52.9

Sources: RIS based on WDI CD-ROM, 2007; WDI, 2008 (print version); *UNCTAD Handbook of Statistics 2006-07.*

Outlook for 2008 and Beyond

The year 2008-09 is a very difficult year. In the first half the economy suffered from inflationary pressures which crossed 12 per cent in June-July 2008. As a result the RBI unleashed the tight money policy. The CRR was increased by 150 basis points and repo rate by 120 basis points. The tight money policy has adversely affected several industries especially the capital goods sector and the consumer durables which are highly dependent upon the availability of credit. In the second half of 2008/09 which we are into now, the inflationary pressures subsided but the slowdown in the global economy started to impact us very severely. The demand squeeze in the advanced economies has started to affect our exports. But much more importantly, the pull out of FII investments from the country because of liquidity squeeze in the West has caused a crash in the stock markets from a peak of 20,000 of BSE Sensex to under 10,000, and depreciation of the rupee by 20 per cent. To save the rupee from falling further, the RBI had to intervene by selling dollars. As a result of FII net outflows and selling of dollars by RBI, foreign exchange reserves have dipped by US$ 50 billion over the five-six months. Crash of stock markets has affected the ability of companies to raise capital in domestic and overseas markets. There is a severe liquidity crunch in the domestic market for both rupees as well as for dollars. However, India's banking sector remained largely unaffected because of prudential regulations and is a source of comfort considering widespread bankruptcies all across the world.

Figure 3: Sectoral Growth Rates



Source: RIS based on data available at http://mospi.nic.in at factor cost, 1999/00 prices.

For arriving at the growth projections for the current year, conventional methodologies of either time trend analysis or determinants are not likely to be appropriate in the face of a severe external shock faced in the year. Therefore, we examine the prospects for growth in the three broad sectors of the economy, viz. agriculture, services, industry, on the basis of performance in the 2007/08 and 2008/09: Q1 that are available. The projections for the economy will be derived on the basis of sectoral estimates, given their weights.

Agriculture

Agriculture which has a 19 per cent weight in GDP is still highly dependent upon monsoon. In view of the fact that this year there was a relatively normal monsoon, the projection for agriculture growth can be conservatively put at 3 per cent, as achieved in the first quarter and compared to 4.5 per cent achieved in the previous year.

Services

Services which is the largest sector of the economy with 54 per cent weight in GDP, has shown some effect of slowdown especially in IT exports because Indian companies supply quite a lot of software to the financial sector in the Western world which is reeling under the crisis. But there are counteracting tendencies such as the enhanced need of the businesses in the Western world to put more emphasis on cost cutting through more outsourcing. Another counteracting tendency is in the form of the payout of the 6th Pay Commission which is likely to make the public services segment of services grow stronger. So we can put our projections for this year for services at 9.5 per cent, which appears reasonable in view of a 10.7 per cent growth achieved last year, and 10.2 per cent in the first quarter of the current year.

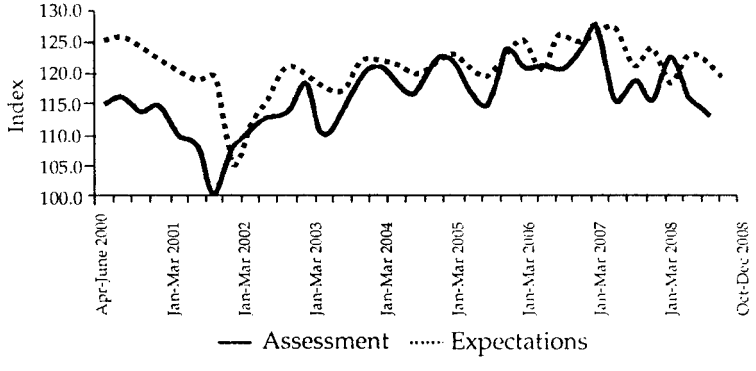
Industry

Industry which has 27 per cent weight in the GDP seems to be the worst affected sector from the crisis. Newspapers are full of bad news about industry with companies cutting output

and jobs and collapse of stock markets. Capital goods demand was affected by high interest rates in the first half of the year. Although the interest rates are now easing but the damage has been done in the first two quarters. The demand for some goods and services continues to be robust; for instance, October saw the largest ever sale of new mobile connections, 7.7 million in one month. The export demand is declining leading to export growth decelerating to 10 per cent in September 2008 and declining by 15 per cent in October 2008. The worst affected exports are those of labour-intensive goods such as textiles and garments, handicrafts, gems and jewellery. Then CMIE which is tracking the corporate annual reports and the first quarter and second quarter results, feels that there is not so much damage apparent as yet on the companies, and their bottom lines are good. Of course there is some slowdown but not too much. Similar kinds of perceptions have been reported by the CII-Price Waterhouse Coopers Survey, the HT-CNN-IBN Surveys as also the RBI industrial Outlook (see Figure 4) which shows some slowdown but not a too dramatic slowdown.

In view of the above, the projection for 2008-2009 for industrial growth can be put at 5 per cent. Considering the previous year growth of 8.1 per cent, and the first quarter growth of 5.2 per cent, 5 per cent would seem a reasonable growth target for this year unless the downturn deepens.

Figure 4: Reserve Bank's Industrial Outlook Survey— Business Expectations Index

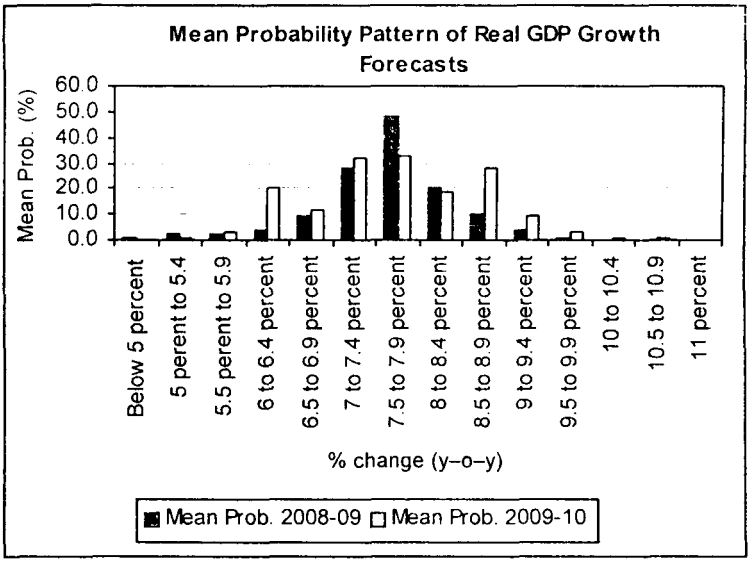


Source: RBI.

Growth Outlook for the Economy

The projected growth of the three broad sectors, viz. agriculture at 3 per cent, services at 9.5 per cent, and industry at 5 per cent gives us a GDP growth rate of 7.1 per cent for 2008/09. It is also consistent with the poll forecasts as put out by RBI with median forecast for the Indian economy to be for 7.5 per cent growth rate. Compared to the 9 per cent growth achieved in 2007/08, the 7.1 per cent forecast represents a major slowdown by nearly 2 per cent points. But it is a very robust growth in the current scenario of depression, making India one of the fastest growing economies in the world. Other than China there is hardly any country which is still able to manage 7 per cent growth in the current circumstances.

Figure 5: Survey of Forecasts of Indian Growth Rates for 2008/09



Source: RBI

It is interesting to note that after the above projections were made in November 2008, the Economic Advisory Council (EAC) to the prime minister, in its report of January 2009, has also come up with the same figure of 7.1 per cent for 2008/09

(EAC 2009). The CSO has also projected the 7.1 per cent growth rate for the Indian economy in 2008/09 in its advanced estimates of national income released on 9 February 2009 (CSO 2009). Therefore, the projections made here have since been corroborated by the government sources and statistical agencies, although IMF has downgraded the growth outlook for India for 2009 to 5.1 per cent and to 6.5 per cent in 2010 in its January 2009 *WEO Update*.

Outlook for 2009, 2010 and beyond

Although the outlook for all emerging economies and the G3 economies for 2009 and 2010 is a further worsening of the crisis (as indicated earlier), the prospects for the Indian economy could improve. There are two-three factors that may assist the Indian economy in turning the corner faster than others. First, the next year is not going to have the adverse effect of liquidity problems and the tight money policy which the Indian economy faced in the first half of 2008/09. Second, the oil prices which had risen to US$ 140 in the first half of this year have eased and because there is a slowdown in the global economy, they will remain very low and already they have come down to nearly US$ 40 a barrel. In view of India's very heavy reliance on oil imports, it would help. Third, the fuller effect of the implementation of the 6th Central Pay Commission (CPC) recommendations will be felt in 2009/10 which is acting like a fiscal stimulus and will put a lot of money in the system through raised government salaries and arrears. All these factors might help the Indian economy to recover some of the lost ground next year especially in the second half of the year. Therefore, it is possible that the Indian economy achieves a growth rate of up to 7.5 per cent in 2009/10.

While agencies such as the IMF have downgraded the growth outlook for India for 2009 and 2010, the EAC of the PM also expects the Indian economy to turn the corner in the second half of 2009/10 and cloak a rate of growth between 7 and 7.5 per cent or thereabouts.

Long-Term Outlook

The long-term outlook for the Indian economy continues to remain very robust. Hopefully the Indian economy will come out of the current crisis fairly soon and get back on the growth trajectory that it had become used to in the past five years.

India's potential to sustain rapid growth rates in the future is widely annotated. Goldman Sachs' BRICs study has remarked that 'India has the potential to show the fastest growth over the next thirty and fifty years' (Wilson and Purshothaman 2003). They have estimated its per capita growth rate to be above 5 per cent (or over 6.5 per cent in gross GDP) over the next thirty years. An IMF Working Paper projects India's growth rate in 2025 at 7 per cent 'with more upside potential than downside risks' (Rodrik and Subramanian 2004a, b).

Although the Chinese economy has been growing faster than the Indian economy, there are reasons to believe that the Indian economy may be able to catch up with the Chinese economy in terms of growth rates in the future or even surpass it because of the headroom that it has (Kumar 2006b). First, Indian growth has so far been largely fuelled by domestic demand and has yet to exploit the potential of export-oriented manufacture. The country is beginning to get attention as a manufacturing base by MNEs especially in knowledge-based industries and services because of abundant trained human resources. Second, the investment rate can be further increased from about 34 per cent today by enhancing the domestic savings rate and with greater FDI inflows. The investment climate is gradually improving and hence FDI inflows are likely to increase further. China may have exhausted its potential of increasing the domestic savings rate with over 45 per cent and massive FDI inflows. Third, the demographic transition is likely to help India with its growing share of working population over the next 20-30 years while other emerging economies like China have begun to see a gradual reduction in the share of working age population. Fourth, the exchange rate of the Indian rupee is market determined and does not imply significant

adjustment burden as in the case of emerging economies with pegged exchange rates having a potential burden of adjustment in the event of floatation of currencies. Furthermore, the incidence of poverty also indicates pent up potential for generating domestic demand. The millions of people who are currently not a part of the consumer revolution because of lack of purchasing power can join the mainstream with more inclusive growth strategies. Finally, India has a broader base of domestic private enterprises that follow world best practice in corporate governance and are seeking to expand their global presence compared to China where leading national champions are generally state owned enterprises (Huang and Khanna 2003).

It would appear, therefore, that the Indian economy is poised to sustain high growth rates over the next two three decades to emerge as one of the largest in the world. The only downside risk to this optimistic assessment is the ability of the government to deliver on the infrastructure development that has begun to constrain growth. The government appears to be responding to the infrastructure and other formidable challenges that the country faces besides growing interest of foreign investors in infrastructural and industrial investments. All these create optimism for the prospect of India eradicating poverty and joblessness in the coming decades.

4

Quality of Growth and the Role of Infrastructure Development

There has been acceleration of growth but what kind of growth? This is another issue which comes to mind and the obvious question one would ask is whether it has narrowed down disparities. Recent studies analysing the patterns of growth across states found the richer states growing faster and a widening of inter-state disparities in income levels. The ranking of the states by per capita income has not changed much over twenty years. The richer states in 1980 were also the richer ones in 2000 and have been better able to reduce poverty. As a result poverty has become much more concentrated in certain poorer states (Purfield 2006). The other evidence which is available is about inequalities within the states. Recent analysis points to a significant increase in overall inequality in the 1990s, particularly in urban areas, and within all except one state (viz., in Bihar where inequality remained flat, *see* Topalova 2008). This finding suggests a reversal of the trend of declining inequality in the 1980s. Furthermore, with the consumption growth significantly higher for urban areas in the 1990s, the urban-rural gap has widened in most states and in India as a whole (*ibid.*).

The rising inequality between states and within states over the past decade or more is a matter of concern. What could be the factors behind the growth process, private investments and inclusiveness of the growth process? In that context, it is important to check the effect of infrastructure development in explaining the patterns of development across states. Infrastructure is a key factor in driving a country's growth and development. As public goods, availability of quality

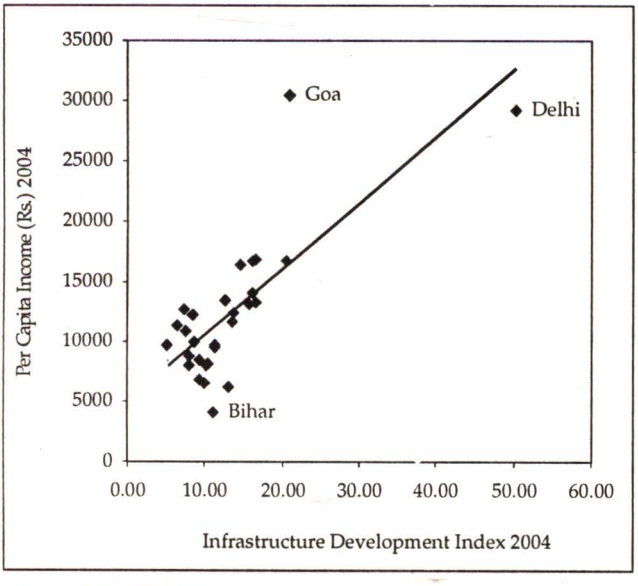
infrastructural facilities assists in mobilizing private investments by reducing the magnitude of required investments. Infrastructure development can also help in narrowing development gaps between developed and laggard states. The role of infrastructure in fostering economic development has been supported by empirical literature. A number of studies have highlighted the importance of physical infrastructure as a determinant of economic growth (e.g. Aschaur 1989; Easterly and Rebelo 1993; and Gramlich 1994; World Bank 1994, for reviews). The favourable role of physical infrastructure in influencing the patterns of private foreign investment (FDI) inflows has been corroborated by a number of studies (e.g. Loree and Guisinger 1995, and Mody and Srinivasan 1996, Kumar 2006a).

In that context we found a very strong positive relationship between level of infrastructure development, (as captured by a comprehensive index of physical and social infrastructure constructed with the help of principal component analysis)[1] and the level of development measured in terms of per capita income across states (Figure 6). Here we were measuring infrastructure development in terms of social and physical: viz., social infrastructure like education and health, physical infrastructure like roads, railways and telecommunications. So infrastructure development seems to have a very strong effect on development in the states.

The infrastructure development index was also found to have a very strong non-linear effect on poverty reduction. Given this non-linearity, the elasticity of infrastructure in reducing poverty is much higher for the poorer states than in the richer states (Figure 7). Therefore, investment in infrastructure development in a poorer state will bring stronger rewards in terms of poverty reduction compared to the similar amount of investment spent in infrastructure development in a richer state. Needless to emphasize that both

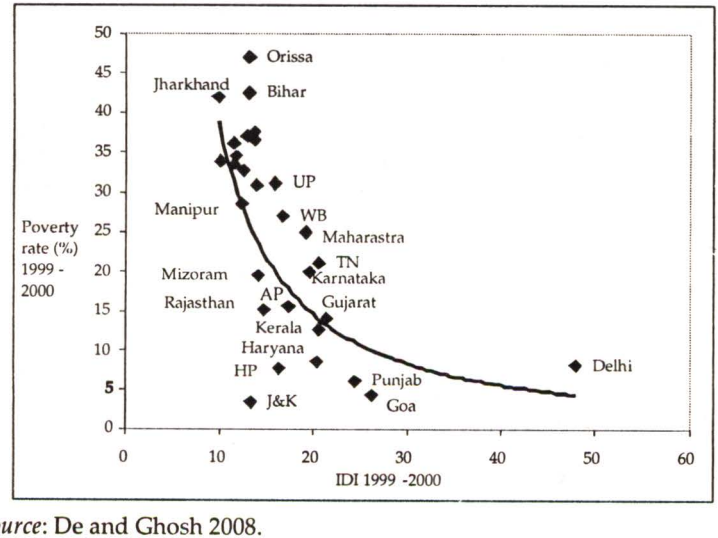
1. *See* De and Ghosh 2008 for details of methodology of infrastructure index construction.

Figure 6: Relationship between Infrastructure Development Index and Per Capita Income Across Indian States, 2004



Source: De and Ghosh 2008.

Figure 7: Observed Relationship between Infrastructure Development Index and Poverty Rates Across States



Source: De and Ghosh 2008.

social as well as physical aspects of infrastructure are equally critical and have been incorporated in the infrastructure index used.

Finally, it is worth emphasizing on the role of public investment in driving infrastructure development or filling the infrastructure gaps. Public investment has to lead the way and crowd-in more private investment for infrastructure development, as highlighted further.

5

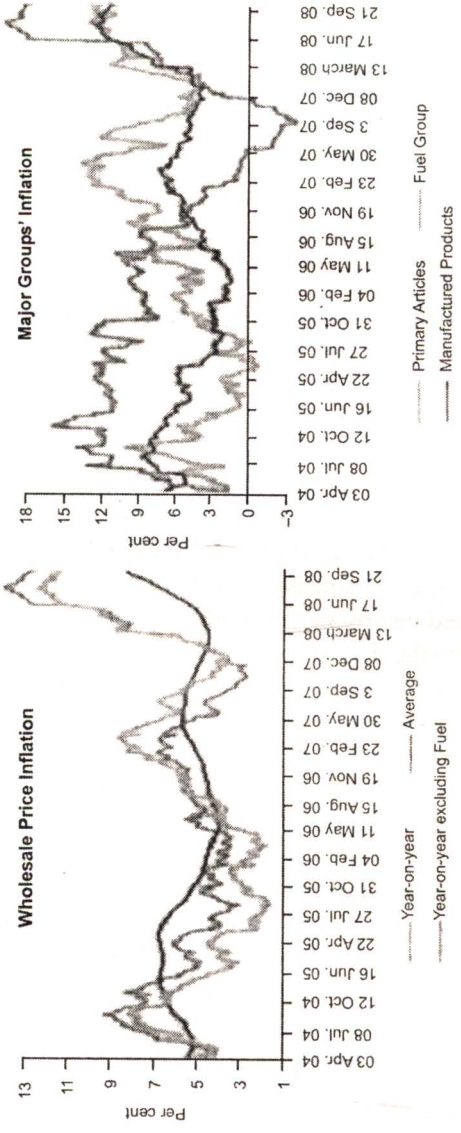
Prices and Fiscal Balance

Inflation

After a number of years of relative price stability, inflation became a major cause of concern in the first half of the year 2008/09 crossing a level of 12 per cent (see Figure 8). The inflation was largely led by rising international prices of important commodities including rising oil prices which went through the roof with US$ 140 per barrel, prices of several metals like steel and copper soaring by over 100 per cent as well as the price of cereals among other commodities. However, with the onset of the global recession oil prices and other commodity prices started easing in the world markets, bringing the inflation rate in India down too. Oil prices have since crashed to just around US$ 40 per barrel with slowing global demand. Metal prices have also come down dramatically with global recession, with inventories piling up at the plants. As a result the inflation rate started easing in the country as well. By the end of 2008, inflation rate had come down to less than 6 per cent.

Rising prices of cereals and other commodities world wide had attracted a global debate. Rising consumption in emerging countries such as China and India was blamed for the rising prices while the real reasons might lie in increased conversion of food commodities such as corn into biofuels in the developed countries such as the US and in speculation (Box 3).

Figure 8: Inflation in India

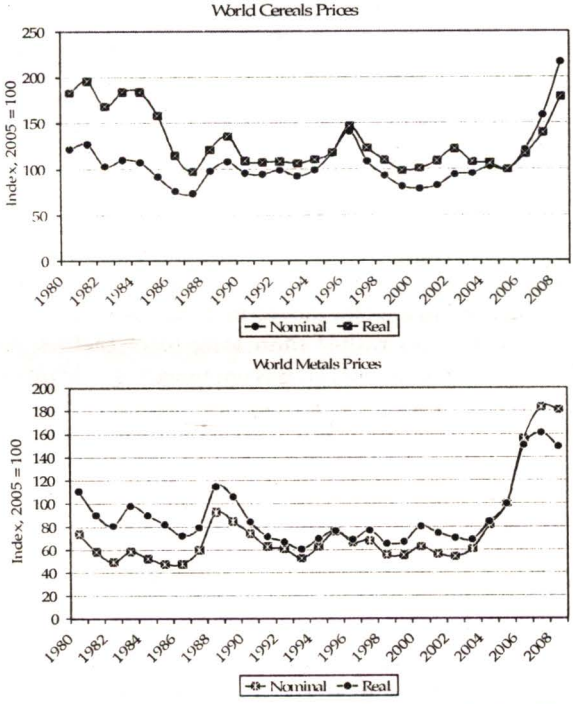


Source: RBI

Box 3: Factors Explaining Rising Food Prices

The movement in prices of food over the last decades presents a puzzle. The nominal price index of food grains had been largely stable between 1980 and 2006. In fact when adjusted for inflation (export prices of manufactures from developed countries), the prices of food grains have been going down. A similar picture emerges for price of metals and oil (see chart 1).

Chart 1: World Commodity Price Situation



Source: RIS based on IMF (2008), *World Economic Outlook Database*, April; and own calculations.

Note: The export price of manufactures in US dollars for advanced economies (index, 2005 =100) has been used as price deflator. Cereals include wheat, maize (corn), rice and barley. Metals include Copper, Aluminum, Iron ore, Tin, Nickel, Zinc, Lead, and Uranium.

Source: RIS (2008) based on IMF (2008), *World Economic Outlook Database*, April.

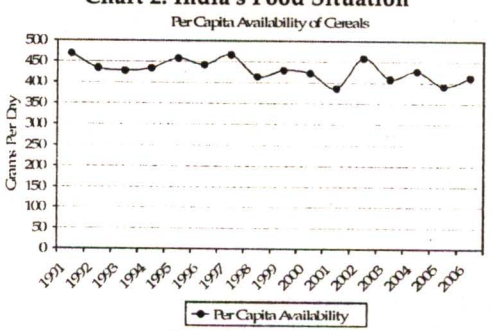
(*continued*)

(*continued*)

Crude oil (petroleum) price index is the simple average of three spot prices (APSP)- Dated Brent, West Texas Intermediate and the Dubai Fateh.

In explaining the rise in commodity prices, it is sometimes argued that it is the rising prosperity in the emerging economies, in particular India and China that is leading to increased demand and hence price rise. This line of reasoning does not seem to be consistent with the time line of prosperity in emerging economies and that of price rise in commodities. The rapid increase in income in emerging economies has been going on for the last two decades while the rise in prices in commodities is a phenomenon of the last two years. In fact for India since 1991 while per capita incomes have been increasing, per capita production of foodgrains has been declining and net exports are increasing and food stocks rising. This has been associated with a decline in per capita food grains availability (see chart 2) of about 17 per cent between 1991 and 2005. This phenomenon is puzzling and requires some in-depth analysis.[1] But so far as the issue of recent price rise in food grains in concerned, there is clearly a need to look for factors that changed dramatically in the last two years rather than long-term factors such as increasing income in emerging economies.

Chart 2: India's Food Situation



Source: RIS 2008.

(*continued*)

1. One possible explanation is switch of demand from foodgrains to other food items and other goods and services as per capita income rises. Another possible explanation is the increase in number of food-deprived persons in certain parts of India who are not participating in the rising prosperity of the country.

(*continued*)

More plausible factors for the rising food prices appear to be (a) sharp increase in corn ethanol and soybean diesel supported by subsidies, particularly in the US and EU; (b) sharp increase in securitization of commodities leading to speculative price rises of many commodities, and (c) the effect of current and expected depreciation of the USD.

In the US, corn production for ethanol increased from 41 Mt in 2005-06 to 79Mt in 2007 when it accounted for about 24 per cent of production, and 83 per cent of global corn exports. With increasing oil prices, bio ethanol production is increasing sharply in the US, the EU as well as in Brazil and China. The finance minister of India, P. Chidambaram, has dramatized the issue calling this conversion from food to fuel "a crime against humanity."

Even more powerful (though hopefully temporary) is the effect of increased speculative activities in commodity markets. In the wake of decline in equity markets, investors are being lured into commodity futures and there has been increased securitization of commodities. As the speculation about increased commodity prices spreads and there is huge liquidity waiting to move out of equities, it is natural that present and future commodity prices will shoot up. It is only such speculative factors rather than any long-or medium-term factors that can explain single day surges of about 30 per cent in prices of rice and wheat as happened in early 2008.

Working along side these speculations about future commodity prices are speculations about the declining value of USD, which is often the unit of account for commodity markets. As the USD is depreciating, commodity markets are beginning to build in the currency risk in their quotations. More generally, reduced liquidity preference for the USD may be encouraging a switch from money to commodities fueling the inflationary pressures. IMF estimates that under a scenario in which the U.S. exchange rate remained at its peak of early 2002 until end-2007 "nominal gold prices would have been lower by around $250 a troy ounce, crude oil prices would have been lower by around $25 a barrel, and non-fuel commodity prices would have been lower by around 12 per cent." (IMF 2008:50)

Over the medium and long term, increasing income in the emerging economies can indeed be expected to increase demand for commodities and every effort should be made to increase productivity of agricultural products in developing economies to increase supply. In many developing economies (including India and Africa), per acre productivity of foodgrains is nearly

(*continued*)

(*continued*)

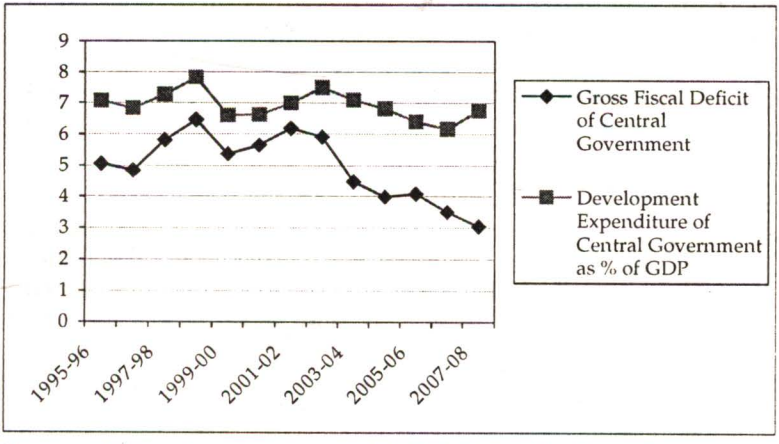
50 per cent of that in more advanced economies. Neglect of public investment in agriculture including irrigation and technology promotion has been a factor behind this poor performance in the last decade or so and that must be corrected in the future. For petroleum and metals, elasticity of production may not be high and demand management may have to be the key for price stabilization. This leads to the need for drastic reduction in energy-intensive consumption and production patterns particularly in developed countries (but increasingly also in emerging economies). Thus the programmes and policies for changing the carbon intensive lifestyle in both developed and developing economies are needed not just to manage the long-term consequences of climate change but also to manage inflation in the short and medium-term. And while these long-term measures are in preparation, international financial system must the reformed and excesses of speculation in commodity markets checked so that they do not compound the already difficult situation on commodity prices.

Source: RIS (2008).

Fiscal Consolidation

In terms of fiscal consolidation, a remarkable progress has been made in terms of fiscal deficit as a percentage of GDP coming down from 5.9 per cent in 2002-03 to 3.05 per cent 2007/08. These figures can underplay the extent of fiscal deficit if there is considerable off-budget spending. The fiscal consolidation has been helped by buoyant tax revenues in the past six years because of growth acceleration and the discipline brought by the Fiscal Responsibility and Budget Management Act. However, an important issue to be looked at is the quality of deficit. It matters whether the fiscal consolidation is achieved by cutting the current expenditure or development expenditure. Figure 9 shows that fiscal deficit of the central government has come down in the recent years. However, as the proportion of development expenditure in GDP has also come down, a part of the fiscal consolidation has been achieved at the expense of development expenditure which could affect the long-term sustainability of growth.

Figure 9: Fiscal Deficit and Development Expenditure

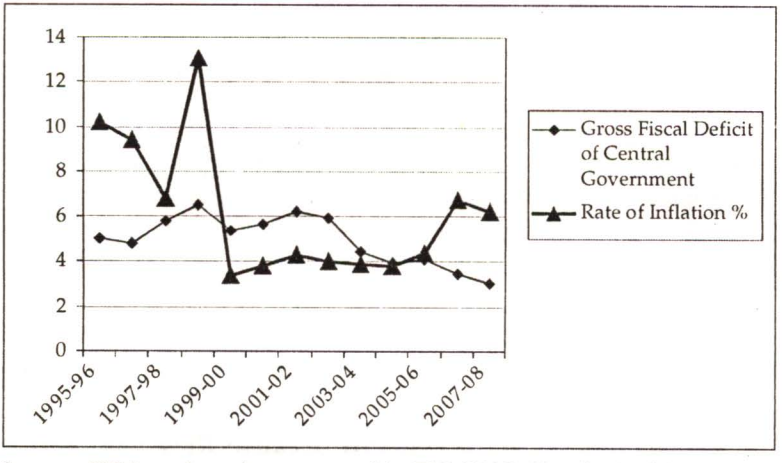


Source: RIS based on data reported in RBI (2008) *Handbook of Statistics on Indian Economy*.

Fiscal deficits are a concern because they can lead to inflationary tendencies. However, there is no theory on what level of fiscal deficit is good for an economy. In practice some rules of thumb are applied such as 5 per cent of GDP or 3 per cent of GDP. Many of these rules of thumb have been based on the experiences in the matured economies in the West. For instance the 3 per cent target for fiscal deficit has been a part of the Maastricht Criteria that the EU member states had to comply with in order to move towards monetary union. It can be argued that a level that is good for matured economies such as the European Union may not be appropriate for an expanding economy such as India. Yet we have adopted a 3 per cent target for fiscal deficit under FRBM Act. In an expanding economy like India's, there is much more fiscal space than is commonly believed. In Figure 10 there is no apparent relationship between fiscal deficit and the rate of inflation in India. One is not making a case for fiscal profligacy but at the same time one need not be over concerned with respect to meeting the targets of fiscal consolidation that have been evolved in the context of matured economies that have very

different macroeconomic conditions and needs for development expenditure and public investment compared to developing economies.

Figure 10: Fiscal Deficit and Rate of Inflation

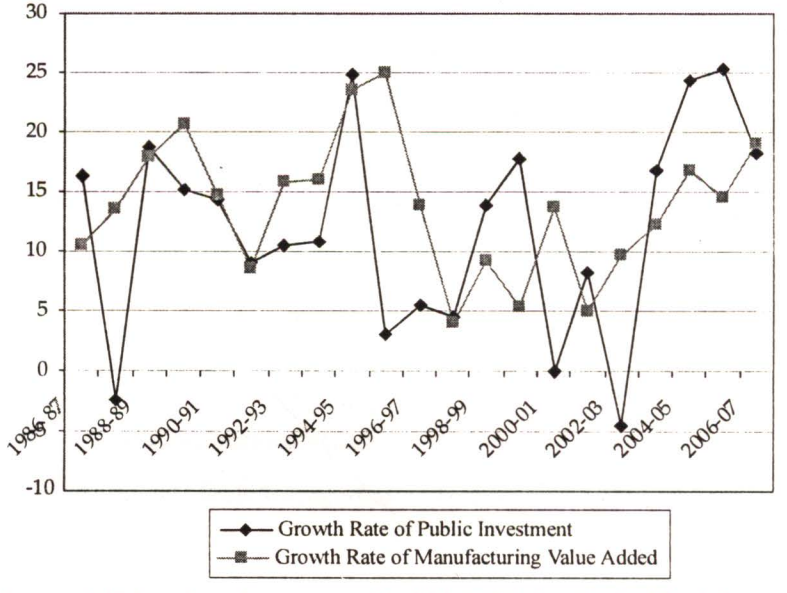


Source: RIS based on data reported in RBI (2008) *Handbook of Statistics on Indian Economy*.

Public investment plays a very important role in driving the industrial development of the country in crowding-in private investment by development of infrastructure and by creating demand for industrial goods and accelerating growth as is shown in Figure 11. Therefore, achieving fiscal consolidation by reducing public investment or development expenditure may cost dearly in terms of growth and development.

Hence, an obsession with targets of fiscal consolidation worked out for developed countries needs to be moderated especially in the context of global recession and need for fiscal stimulus.

Figure 11: Public Investment and Industrial Growth in India



Source: RIS based on data reported in RBI (2008) *Handbook of Statistics on Indian Economy*.

6

Trade and Balance of Payments

As a result of economic reforms and trade liberalization, the Indian economy has become gradually more open as reflected in the rising trade to GDP ratio which more than doubled from 13.8 per cent in the mid-1980s to 34.4 per cent (Table 3). The trade openness will be much higher if we were to also take into account the services trade.

Table 3: Proportion of Trade in GDP

Trade as % of GDP

	Trade as % of GDP
1985-87	13.8
1990-92	19.0
1996-98	25.2
2000-02	28.5
2005	34.4

Source: RIS based on WDI CD-ROM, 2007; WDI, 2008 (print version) and RBI 2008.

India's exports and imports have grown at robust rates of growth of over 25 per cent on average during 2002-08 (Table 4). However, the growth rates will be affected by the global recession especially the exports growth, as will be seen later.

Aside from the growth rates that have accelerated over time, the performance of Indian exports in terms of commodity composition and geographical diversification reveal a mixed picture. In terms of commodity composition, they continue to be dominated by relatively simple, slow moving and low value-

adding products such as ores and minerals, plantations and other primary agricultural commodities, textiles, garments, leather goods, and increasingly refined petroleum products (Table 5). India has not been able to diversify its export basket in favour of more technology-intensive, knowledge-intensive goods that are less susceptible to price pressures, more value adding and faster growing.

Table 4: Growth Rates of Merchandise Trade (growth rates in per cent)

Year	Export growth rate	Import growth rate
1995	20.3	21.6
1996	5.6	12.1
1997	4.5	4.6
1998	-3.9	-7.1
1999	9.5	16.5
2000	19.6	7.0
2001	0.0	-2.8
2002	20.3	14.5
2003	24.1	24.1
2004	48.6	48.6
2005	32.1	32.0
2006	21.8	26.2
2007	28.5	20.0
2008P	22.0	19.2

Source: ADB, *Asian Development Outlook, 2008.*

On the other hand, India has done very well in terms of geographical diversification of trade, having progressively reduced dependence on the developed economies especially Europe and North America and has enhanced focus on Asian countries especially in favour of ASEAN and West Asia and North Africa region. Asia now accounts for over 51 per cent of India's exports. In view of sharp contraction in demand in North America and Europe because of depression in these economies, this lower dependence on them represents a silver lining.

Table 5: India's Exports by Commodities (US $ million)

Commodity Groups	2007-08	% of Total	2005-06	% of Total	2003-04	% of Total
I) Primary products	25078.00	15.77	15721.00	9.89	9697.00	6.10
A) Plantation	966.00	0.61	750.00	0.73	593.00	0.93
B) Agricultural and allied products	13404.00	8.43	7219.00	7.00	5407.00	8.47
C) Marine products	1703.00	1.07	1589.00	1.00	1329.00	0.84
D) Ores and minerals	9005.00	5.66	6164.00	3.88	2369.00	1.49
II) Manufactured products	133929.00	84.23	87369.00	84.75	54146.00	84.81
A) Leather and manufactures	3432.00	2.16	2698.00	2.62	2163.00	3.39
B) Gems and jewellery	19657.00	12.36	15529.00	15.06	10573.00	16.56
C) Chemicals and related products	21680.00	13.63	15619.00	15.15	9960.00	15.60
D) Engineering goods	33243.00	20.91	19303.00	18.72	10516.00	16.47
E) Electronic goods	3351.00	2.11	2268.00	2.20	1805.00	2.83
F) Textiles	18092.00	11.38	15545.00	15.08	12205.00	19.12
G) Handicrafts	461.00	0.29	462.00	0.45	500.00	0.78
H) Carpets	920.00	0.58	853.00	0.83	586.00	0.92
I) Cotton raw incl waste	1987.00	1.25	656.00	0.64	205.00	0.32
J) Petroleum products	24869.00	15.64	11640.00	11.29	3568.00	5.59
K) Unclassified	5977.00	3.76	2515.00	2.44	1881.00	2.95
Exports	159007.00	100.00	103091.00	100.00	63843.00	100.00

Source: RIS based on Department of Commerce data posted at http://commerce.nic.in.

Balance of Payments (BOP)

After many years of rather comfortable balance of payments situation, India is entering a period of bop stress. In 2007/08 the trade deficit widened very rapidly to US$ 92 billion due to rising oil prices and other imports (Table 6). Due to a surplus of nearly US$ 75 billion in services trade, the current account deficit was contained within the 1.5 per cent of GDP in 2007/08. Furthermore, the strong capital inflows adding up to US$ 108 billion in the year not only absorbed the current account deficit but also enabled the country to augment its foreign exchange reserves. In the first half of 2008/09, the trade deficit already widened further to US$ 69.2 billion compared to $ 38.6 billion in the previous year for the same period due to high oil and other commodity prices. Even though the surplus in services trade increased, the current account deficit had widened to US$ 22.3 in the first half of the year compared to just US$ 17 billion in full 2007/08. In the second half of the year as exports start to shrink due to global recession and imports continue to rise, there is threat of further widening of the current account deficit to 2.5 per cent of GDP.

An issue of concern in respect of bop in the current year is the trend of declining capital flows. During the 2007/08, India received a substantial inflow of foreign capital adding up to US$ 108 billion (Table 7). These capital inflows not only helped the country bridge the current account deficit but also enabled it to augment its foreign exchange reserves. However, in the year 2008/09, there has been a net inflow of only US$ 19.9 billion in the first half compared to US$ 50.9 billion in the corresponding period of the previous year. In the second half of the year, it could be worse as the foreign institutional investors began pulling out their investments in the country and FDI inflows began to decline due to recession in the Western world. In other words, the bop situation is likely to worsen in the second half of the year with the current account deficit widening and capital flows not keeping pace with the trend. Yet, it is far from a crisis situation given our large forex reserves compared to 1991 when we faced a liquidity crisis. To

some extent, a current account deficit helps the country absorb net foreign savings such as FDI inflows. Nonetheless, a current account deficit of the order of 2.5 per cent is not healthy so we should not be complacent. That will mean promoting our exports more vigorously but also leveraging the sizeable domestic market for substituting imports of many products by starting domestic manufacturing. We shall revert to this in the section on policy options.

Table 6: India's Balance of Payments

(US $ billion)

Item	2007-08 PR	2007-08 PR			2008-09		
	April-March	April-June	Jul-Sept.	April-Sept.	April-June PR	July-Sept. P	April-Sept. P
1	2	3	4	5	6	7	8
Exports	166.2	34.4	38.3	72.6	49.1	47.7	96.7
Imports	257.8	56.3	59.5	115.9	79.6	86.3	165.9
Trade balance	-91.6	-22	-21.2	-43.2	-30.6	-38.6	-69.2
Net invisibles	74.6	15.3	16.9	32.3	20.8	26.1	46.8
Current account Balance	-17	-6.7	-4.3	-11	-9.8	-12.5	-22.3
Net capital Account	108	17.8	33.2	50.9	11.8	8.2	19.9
Overall balance*	92.2	11.2	29.2	40.4	2.2	-4.7	-2.5

Note: PR : Partially Revised.
P : Preliminary.
* : Overall balance includes errors and omissions.
Source: Reserve Bank of India.

7

Capital Flows and Their Impact

Foreign Institutional Investment (FII) Inflows

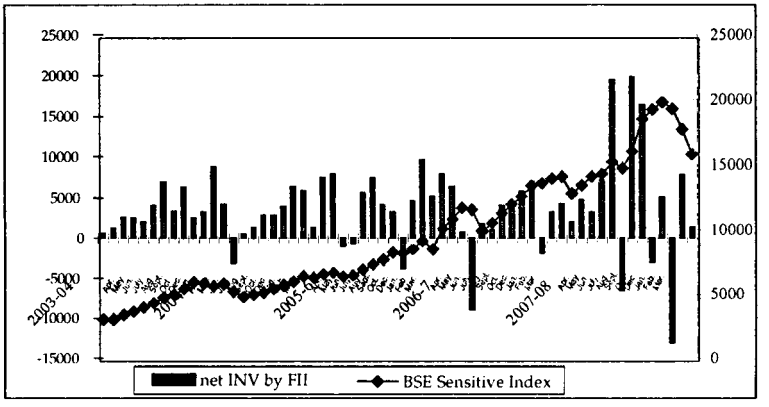
With the capital markets integration, capital inflows have become very important channels of transmission for the Indian economy of external shocks. In particular, in view of the good performance of India's stock markets, exposure to inflows from foreign institutional investors has increased in the last few years. In the year 2007-08 India had a net inflow of US$ 29 billion of FII. This sizeable inflow on the Indian bourses led to not only stock prices booming with BSE Sensex more than doubling from under 10,000 to 20,000, but also the exchange rate of rupee going up from 47 rupees to a dollar to 38 rupees to a dollar. The sharp appreciation of the rupee by itself was an external shock of sorts adversely affecting Indian exports and calling for a response by the government. In the current year, due to the financial crisis in the Western world, there is already a net outflow of FIIs to the tune of US$ 6.5 billion up to September 2008. Since October 2008, the trend of FII outflows has become more pronounced. Apparently US$ 22 billion had gone out between April to November 2008. This is a large outflow of resources even for an economy of India's size and has expectedly brought down the stock markets from over 20,000 points of BSE Sensex to under 9,000 points. Much more importantly it has led to a sharp depreciation of the rupee by nearly 20 per cent. The depreciation would have been more had RBI not intervened in the market by selling dollars. This process of net outflows

of FIIs and selling of dollars to protect the rupee from going down further led to foreign exchange reserves getting depleted by US$ 60 billion, to about US$ 250 billion from $310 billion.

In the past two years the rupee has been on a roller coaster ride: from Rs. 48 per dollar in 2007 to Rs. 38 in February 2008 to again Rs. 48 to a dollar in November 2008. Such wild variations in the exchange rate can be highly disruptive for the economy in general and industry in particular. They have to constantly adjust themselves to the exchange rate fluctuations. In case the appreciation is of a structural nature resulting from sustained trade surplus, it could be self-correcting. However, in India's case we have a situation of widening trade deficit combined with appreciation of rupee as observed in 2007/08. The role of FII inflows in influencing both the stock prices and exchange rate of rupee is clear from Figures 12 and 13 respectively.

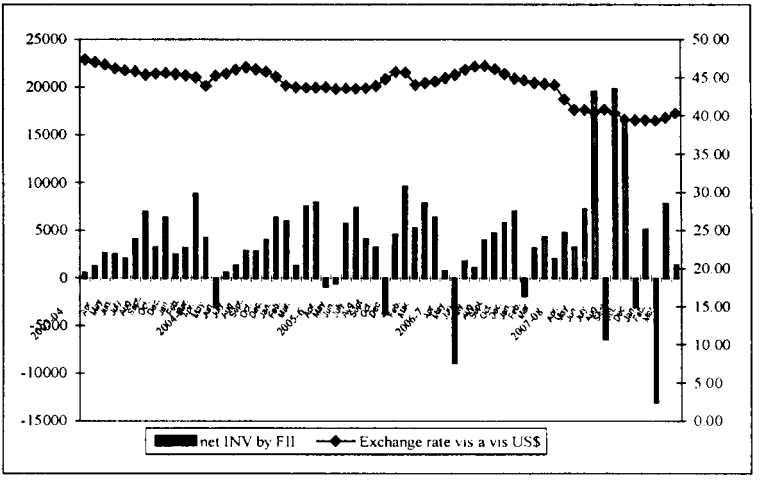
Besides their role in bringing inherent instability in the economy to stock markets and exchange rates, what is not very well recognised is the fact that FII flows come at a very heavy cost. In terms of the servicing burden of foreign money, among other alternatives such as FDI, foreign borrowings, NRI deposits, or ADRs/GDRs, the FII investments are most expensive. This is because they come to chase good returns at the stock markets and will not come if the stock markets are not giving good returns. Since they chase good speculative returns, obviously the servicing burden for the host economy becomes much higher. In 2007/08, Indian stock markets were giving around 44 per cent return. That means for every dollar India received in FII flows, it became liable to pay $1.44 in one year. In view of their high cost and their other deleterious effects such as those on exchange rates and stock markets, it is desirable to moderate these inflows. India, instead should try to mobilize NRI deposits which are cheaper and more stable unlike FII investments.

Figure 12: FII Inflows and BSE Sensex (Right Scale)



Source: RIS based on RBI data.

Figure 13: FII Inflows and the Exchange Rate of Rupee (Right Scale)

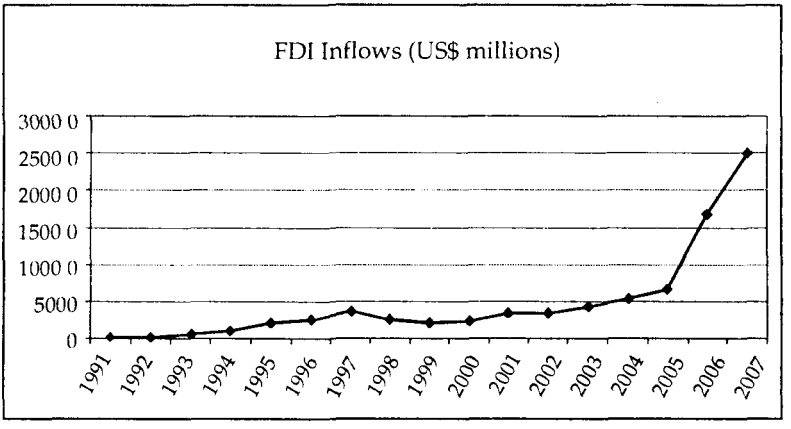


Source: RIS based on RBI data.

Foreign Direct Investment (FDI) Inflows and Their Quality

The quantity or magnitude of FDI inflows has steadily increased all through the post-1991 period except for a decline during 1997-2000 in the wake of the East Asian crisis. As the economy got on to a higher growth trajectory since 2003, FDI inflows grew from $ 4.3 billion in 2003/04 to $ 5.7 billion in 2004/05 to $ 6.6 billion in 2005/06 to nearly US$ 17 billion in 2006/07. In 2007/08, FDI inflows are estimated to have crossed US$ 25 billion (Figure 14).

Figure 14: FDI Inflows in India, 1991-2007



Source: Based on UNCTAD data.

. To put these figures in a comparative perspective, one would find that FDI Inflows attracted by China have been much higher at about US$ 70 billion. However, as the Chinese economy is nearly two and a half times the Indian economy, one has to normalize the inflows by a macro aggregate to get a fair comparison. In Table 7 comparative figures of FDI inflows, normalized by gross fixed capital formation in the two countries, are shown. It would appear that the ratio of FDI to GFCF which was less than half of Chinese level in 2005, crossed the Chinese level in 2006. It would appear therefore that the gap between China and India in terms of magnitudes of FDI is closing.

It would be interesting to know whether the recent surge in FDI flows to India is resulting from growth resurgence or whether the recent growth surge has been a result of FDI inflows. A more detailed analysis of growth-FDI relationship is reported later. The investment climate or relative attractiveness of a country for FDI is determined by a number of factors. FDI inflows are affected by the trends in the macroeconomic performance of a potential host economy. In particular, the growth rate of an economy or of its industrial sector may act as a signalling device on the potential of the economy and pull more FDI. In Figure 15 the broad correspondence in industrial growth rates in a year and FDI inflows in the following year has been portrayed. Apparently, good industrial performance tends to crowd-in FDI inflows as well (Kumar 2005a).

Table 7: FDI Inflows as a Percentage of Gross Fixed Capital Formation

	2005		2006	
	FDI Inflows US$ million	FDI as a proportion of Gross Fixed Capital Formation %	FDI Inflows US$ million	FDI as a proportion of Gross Fixed Capital Formation %
India	6676	3.6	16881	8.7
China	72406	8.8	69468	8.0

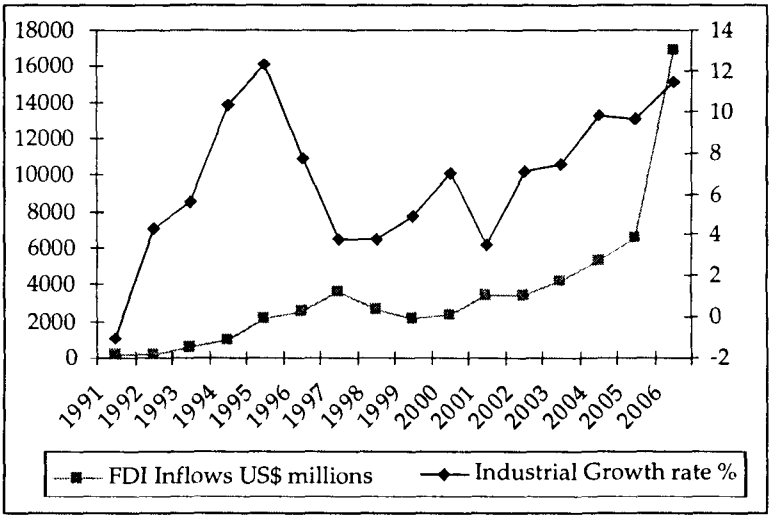
Source: Based on UNCTAD data.

The improvement in the FDI climate in India is evident not only from the rising trend of FDI inflows but also from the investor surveys conducted by global consultancy organisations. Among others, India has moved up from sixth place to second in terms of FDI confidence index published by AT Kearney, a global consultancy organisation. Similar enhancement in India's ranking has been reported by the surveys of investors conducted by the Japanese Bank of International Cooperation (JBIC).

Quality of FDI Inflows

There can be several indicators of quality of FDI inflows as observed above. In what follows, we discuss India's performance in terms of a few such indicators.

Figure 15: FDI Inflows and Industrial Growth Rates in India



Source: based on UNCTAD and Government of India data.

Sectoral Composition

One of the indicators of quality is the sectoral composition of FDI inflows. It matters whether FDI is going to the new technology-intensive sectors and building productive capabilities or to conventional sectors crowding out domestic investments. In terms of the sectoral composition of FDI inflows, there is a shift since 1991 in India's case. Earlier the bulk of FDI inflows used to be directed to manufacturing especially the high technology industries through a selective policy. After the liberalization, a substantial proportion of FDI inflows has been directed to services. Manufacturing has accounted for only about 40 per cent of inflows in the post-1991 period with services accounting for about 35 per cent share. Furthermore, among

the manufacturing subsectors, FDI stock in post-1991 period is also more evenly distributed between food and beverages, transport equipment, metals and metal products, electricals and electronics, chemicals and allied products, and miscellaneous manufacturing unlike a very heavy concentration in relatively technology intensive sectors, viz. machinery, chemicals, electricals, and transport equipment up to 1990 (Kumar 2005a). In China, on the other hand, the bulk of FDI inflows has been directed by the government policy and very little has gone to services (Yongding 2006). Of the FDI in manufacturing in China, 11 per cent has gone in electronics and telecommunication equipment, helping it to emerge as the leading producer and exporter of these products. A policy guiding FDI inflows to manufacturing has helped in China's emergence as a global factory. Therefore, FDI inflows in China have been directed to assist in industrial development of the industry that has made China a global factory generating in the process billions of dollars of output and exports and millions of jobs.

Impact of FDI on Growth and Domestic Investment

FDI inflows could contribute to the growth rate of the host economy by augmenting the capital stock as well as with infusion of new technology. However, high growth rates may also lead to more FDI inflows by enhancing the investment climate in the country. Therefore, the FDI – growth relationship is subject to causality bias given the possibility of two-way relationship. What is the nature of the relationship in India? A recent study has examined the direction of causation between FDI and growth empirically for a sample of 107 countries for the 1980s and 1990s period. In the case of India, the study finds a Granger neutral relationship as the direction of causation was not pronounced (see Kumar and Pradhan 2005, for more details of the methodology and results). Furthermore, it has been shown that some times FDI projects may actually crowd-out or substitute domestic investments from the product or capital markets with the market power of their well-known brand names and other resources and may thus be immiserizing (see Fry 1992, Agosin and Myer 2000, for evidence). Therefore, it is important to

examine the impact of FDI on domestic investment to evaluate the impact of FDI on growth and welfare in the host economy. Our study to examine the effect of FDI on domestic investment in a dynamic setting, however, did not find a statistically significant effect of FDI on domestic investment in the case of India (see Kumar and Pradhan 2005 for details). It appears, therefore, that FDI inflows received by India have been of a mixed type combining some inflows crowding-in domestic investments while others crowding them out, with no predominant pattern emerging in the case of India. In the case of East Asian countries such as South Korea and Thailand, the relationship was clearly indicating FDI crowding-in domestic investments. Therefore, the quality of FDI in India in respect of its impact on growth and on domestic investment is of mixed type and leaves scope for improvement.

The empirical studies on the nature of relationship between FDI and domestic investments suggest that the effect of FDI on domestic investment depends on host government policies. Governments have extensively employed selective policies, imposed various performance requirements such as local content requirements (LCRs) to deepen the commitment of MNEs with the host economy. The Indian government has imposed condition of phased manufacturing programmes (or local content requirements) in the auto industry to promote vertical inter-firm linkages and encourage development of auto component industry (and crowding-in of domestic investments). A case study of the auto industry where such policy was followed shows that these policies (in combination with other performance requirements, viz. foreign exchange neutrality), have succeeded in building an internationally competitive vertically integrated auto sector in the country (see Kumar 2005b). The Indian experience in this industry, therefore, is in tune with the experiences of Thailand, Brazil and Mexico as documented by Moran (1998).

FDI and Export-platform Production

A number of developing countries have used FDI to exploit the resources of MNEs such as globally recognized brand

names, best practice technology or by getting integrated with their global production networks, among others, for expanding their manufactured exports. In this respect, China has had a considerable success in exploiting the potential of FDI for export-oriented production. A very substantial (55 per cent) proportion of manufactured exports of China are undertaken by foreign invested enterprises, which account for as much as 80 per cent of all technology intensive exports (UNCTAD 2005). Foreign enterprises while setting up export-oriented production bases had created 23 million jobs by 2003 making China a global factory. The literature also finds the role of export-oriented FDI in bringing world's best practice technology as the affiliate has to compete globally right from the beginning. It also enhances the chances of FDI inflows crowding in of domestic investment and reducing the chances of crowd-out as the foreign affiliate would be mainly catering to the outside markets rather than eating into domestic firms' markets. It would also create fresh possibilities of market information spillovers for domestics firms on export possibilities.

Unlike the East Asian countries, India has not been able to exploit the potential of FDI for export-oriented production. The bulk of FDI inflows in India are market seeking coming for tapping domestic market with the share of foreign affiliates in exports around 10 per cent. Therefore, the quality of FDI in respect of export-orientation is poorer compared to FDI received by East Asian countries. In this respect two observations can be made. The first is that recent studies of export-performance beginning to indicate a relatively superior performance of foreign enterprises in terms of export orientation compared to early studies suggesting a poorer performance of foreign companies (see Kumar and Joseph 2007). Therefore, MNEs are beginning to exploit the potential of India as base for export-oriented production.

The second observation is about the role of host country policies in exploiting the potential of FDI for export-oriented production. A quantitative study analysing the determinants of the patterns of export-orientation of MNE affiliates across

74 countries in seven branches of industry over three points of time has shown that in host countries with large domestic markets, the export-obligations were effective for promoting export-orientation of foreign affiliates to third countries (see Kumar 1998).

Export-obligations have also been employed fruitfully by many countries to prompt MNE affiliates to exploit the host country's potential for export platform production. For instance, in China which has succeeded in expanding manufactured exports with the help of MNE affiliates, regulations stipulate that wholly owned foreign enterprises must undertake to export more than 50 per cent of their output (Rosen 1999: 63-71). As a result of these policies, the proportion of foreign enterprises in manufactured exports has steadily increased to over 55 per cent as observed above.

India has not imposed export obligations on MNE affiliates except for those entering the products reserved for SMEs. However, indirect export obligations in the form of dividend balancing have been imposed for enterprises producing primarily consumer goods (since phased out in 2000). Under these policies, a foreign enterprise was obliged to earn the foreign exchange that it wished to remit abroad as dividend so that there was no adverse impact on host country's balance of payment. Some times a condition of foreign exchange neutrality has been imposed where the enterprise is required to earn foreign exchange, enough to even cover the outgo on account of imports. Therefore, these regulations have acted as indirect export obligations prompting foreign enterprises to export to earn the foreign exchange required by them. The evidence that is available suggests that such regulations have prompted foreign enterprises in undertaking exports. In the case of the auto industry, in order to comply with their export commitments to comply with foreign exchange neutrality condition, foreign auto majors have undertaken export of auto components from India which have not only opened new opportunities for Indian component manufacturers but also in the process found profitable opportunities for business (Kumar 2005b). Hence, exports of auto components from India

are now growing rapidly exceeding the obligations several times over. These regulations have acted to remove the information asymmetry existing in the minds of auto majors about the poor quality of Indian components. In that respect India's experience is very similar to that of Thailand that has emerged as the major auto hub of Southeast Asia (as documented by Moran 1998 and Kumar 2005b).

R&D and Other Knowledge-based Activities and Local Technological Capability

A comparison of R&D intensity of foreign firms in India and in other countries has not been possible due to lack of data. Within the country, foreign firms appear to be spending more on R&D activity in India than local firms although the gap between their R&D intensities has tended to narrow down. A study analysing the R&D activity of Indian manufacturing enterprises in the context of liberalization has found that after controlling for extraneous factors, MNE affiliates reveal a lower R&D intensity compared to local firms, presumably on account of their captive access to the laboratories of their parent and associated companies. The study also observed differences in the nature or motivation of R&D activity of foreign and local firms. Local firms seem to be directing their R&D activity towards absorption of imported knowledge and to provide a backup to their outward expansion. MNE affiliates, on the other hand, focus on customization of their parents' technology for the local market (Kumar and Agarwal 2005).

An important issue is diffusion and absorption of technology brought by foreign firms in the host countries. Some governments have imposed technology transfer requirements on foreign enterprises, e.g. Malaysia. Such performance requirements, however, do not appear to have been very successful in achieving their objectives (UNCTAD 2003). Instead other performance requirements such as local content requirements or domestic equity requirements may be more effective in transfer of technology. As observed above local content requirements and export performance requirements have prompted foreign enterprises to transfer and diffuse some

knowledge to domestic enterprises in order to comply with their obligations. Similarly, the domestic equity requirements may facilitate the quick absorption of the knowledge brought in by foreign enterprises which is an important pre-requisite of the local technological capability, as is evident from case studies of the Indian two-wheeler industry where Indian joint ventures with foreign firms were able to absorb knowledge brought in by the foreign partner and eventually become self-reliant not only to continue production but even to develop their own world class models for domestic market and exports on their own (see Kumar 2005b). Some have expressed the view that domestic equity requirements may adversely affect the extent or quality of technology transfer (Moran 2001). However, it has been shown that MNEs may not transfer key technologies even to their wholly owned subsidiaries abroad, fearing the risk of dissipation or diffusion through mobility of employees. Furthermore, even if the content and quality of technology transfer is superior in the case of a sole venture than in the case of a joint venture, from the host country point of view, the latter may have more desirable externalities in terms of local learning and diffusion of the knowledge transferred.

8

Policy Responses to Meet the Challenges

The foregoing has made it clear that Indian economic growth has slowed down considerably in the current year after recording a robust rate of nearly 9 per cent on average over the past five years. While the global financial crisis, the most severe since the 1930, has done much of the damage, the growth momentum was also affected adversely in the first half of 2008/09 by the tight money unleashed by the RBI to contain inflation. The growth is flagging in many sectors especially the labour-intensive export-oriented ones with exports shrinking; vulnerable sectors such as SMEs, particularly those making handicrafts or apparel feeding export markets are finding it hard to survive. Larger companies are cutting production and postponing capital investments, in turn adversely affecting the jobs. The stock markets have crashed because of foreign institutional investors (FIIs) pulling out their investments in India while also bringing pressure on the Indian rupee. It has become difficult for enterprises to raise capital in India and in international markets. Although the Indian economy may still manage to grow at 7 per cent, one has to gear up for the further downside risks associated with deepening of recession in the Western world. The IMF is projecting that the G-3 economies, viz. the US, EU and Japan will actually be shrinking in 2009. Hence, emerging economies like India will have to look inwards for the growth stimuli.

Need for a Large Fiscal Stimulus Package

The policy response of the government has so far been limited to easing liquidity by reducing CRR and repo rates. A Rs. 50,000

crore fund is also being contemplated for lending to infrastructure projects. Some more initiatives to subsidize home loans and provide incentives to exporters of labour-intensive goods, among others, are being taken. While all these steps are in the right direction and should be expeditiously taken, there is need for doing more to revive the growth momentum.

What is needed is the Keynesian mindset to revive the growth momentum. For the size of the Indian economy, a fiscal stimulus of the order of US$ 50 billion (or roughly Rs. 250,000 crores) is needed to revive the demand. Such a package of additional spending over the next twelve months will go a long way in reviving the demand and restoring the growth sentiment. The package should target the weaker sections of society to make the growth process more inclusive by paying special emphasis, for instance, on development of rural infrastructure such as rural roads and housing, primary and secondary education, health and sanitation in rural areas which would have high pay-offs in terms of growth and inclusiveness while having low import content besides expediting large infrastructure development projects.

A part of the package could be an adjustment fund for assisting the affected SMEs and workers. The expansion of NREGA scheme to urban areas and to those affected by the crisis could be another priority. Spread over two financial years, viz. 2008/09 and 2009/10 in a ratio of 40 per cent and 60 per cent, this package would entail stimulus of US$ 20 billion and US$ 30 billion respectively in the two years, i.e. 2-3 per cent of GDP and could be monetized rather than funded by public borrowings. The public investments tend to crowd-in private investments and foster growth. Hence, the package may expedite the revival of the economy.

Skeptics would be concerned about the effects of such a package on the fiscal balance and hence on inflation keeping in mind the already stretched fiscal deficit in the current year after including off-budget expenditure. There are two redeeming features to these concerns. First, more than 60 per cent decline in crude oil prices in international markets since the onset of the crisis have provided much needed fiscal space

to the government by reducing the bill of oil and fertilizer subsidies. Second, there is little risk of inflationary expectations in the present scenario of declining demand and depression around the world. The commodity prices have already come down by more than 50 per cent on the back of poor demand. The policy response in different countries around the world has included large fiscal stimulus packages ranging from the government distributing vouchers for promoting spending as in Japan to an ambitious US$ 580 billion fiscal stimulus package announced by China. At this point, the spectre of deflation rather than inflation is lurking on the horizon and there is need for a sizeable package to demonstrate the commitment of the government to reviving the economy. A large considerable package may be more effective compared to many small doses of stimulii.

The other lesson in respect of fiscal stimulus is that rather than cutting taxes, increased expenditure is a more effective way for reviving the demand. Reduced taxes may not lead to increased expenditure when the sentiments are down. Hence the attention should be on enhancing the public expenditure and public investment.

Easing Foreign Exchange Liquidity

The poor liquidity of foreign exchange world-wide is affecting Indian companies in their ability to offer export credit and hence exports. Indian banks and financial institutions like Exim Bank are facing foreign exchange crunch. RBI could put aside US$ 10 billion out of the foreign exchange reserves for lending them to the public sector banks and Exim Bank at the rates that it gets from US Treasury Bills to enable them to lend to Indian companies. This might ease the foreign exchange liquidity.

Paying Attention to Balance of Payments

Deceleration of growth rate is only one of the stresses caused by the global meltdown for the Indian economy. We need to also carefully watch the balance of payments situation in the

context of deteriorating current account balance and net outflow of capital flows, as observed earlier. There is no need to panic, as unlike in the 1991 liquidity crisis, we now have the comfort of large foreign exchange reserves of US$ 250 billion, besides a much more healthy inflow of FDI than we had in 1991. To some extent, current account deficit helps the country absorb net foreign savings such as FDI inflows. Nonetheless, a widening current account deficit is not sustainable so we should not be complacent especially in the context of the global crisis. In this direction, some steps that may be desirable are as follows:

Safeguards against Dumping in an Environment of Excess Capacities

The crisis has led to a situation where we have excess capacities to our west as well as our east because of demand recession in the world economy. As India's economy is still growing at rather robust rate of around 7 per cent, it becomes a very tempting proposition for global suppliers to dump their goods in India. Hence, it is of critical importance to ensure that we do not become a dumping ground for cheap goods destroying our domestic industry in this period of global gloom. Other countries have started to guard themselves against such possibilities. China has, for instance, raised tariffs on a number of goods such as luxury watches from 10 to 30 per cent, cosmetics from 20 to 50 per cent from January 2009 to avert such possibilities. India is placed much more precariously compared to China that has been running large current account surpluses for years building up a trillion dollar foreign exchange reserve. WTO provides the possibility of imposing safeguards such as import surge protection, quantitative restrictions under Articles XII and XVIIIB of GATT in the context of bop crisis. The recent depletion in India's forex reserves by US$ 60 billion is an adequate justification under GATT (Art. XVIIIB) for imposing safeguards. In addition, we could raise tariffs to take advantage of high bound tariffs, or evolving product standards and other non-tariff measures, or just imposing anti-dumping duties. However, we should make

it clear to our trade partners that the objective of such temporary measures is not the protectionist intent but to protect the Indian economy from falling into a severe bop crisis in the context of global recession.

Leveraging Sizeable Domestic Markets to Build Pioneer Industries

In the present scenario of global slowdown, a major thrust on export promotion has its limitations as demonstrated by falling exports in the past two months. Hence, the focus should also be on developing new industries which can leverage our large and expanding market to contain imports. In 2007/08, India imported nearly US$ 60 billion of capital goods—non-electrical machinery and electronic equipment, many of which can be competitively produced in the country now that there is a large domestic demand. In products such as personal computers, telecommunication and power generation equipment, but even in commercial aircrafts, ship building and rigs, domestic market size is now able to support world scale competitive manufacturing units. We could encourage exporters of equipment to start local manufacturing units by offering pioneer industry incentives and offsets programmes as done by the East Asian countries to generate local value added and jobs while saving foreign exchange. The case for infant industry protection is very well-recognised (RIS 2007b). Today Brazil is one of the most competitive producers and exporters of jet planes and it could not have done that without those kind of incentives for a limited period. So we have to go back to the basics and start paying attention to building some new industries.

Consolidating the Presence and Moving up the Value Chains in Traditional Export Industries

For sustaining high growth rates of exports in the medium and long run, India will need to consolidate her presence in the labour-intensive industries such as textiles, clothing and leather goods. In these sectors, main source of advantage arises from low labour costs and vertically integrated industry. As India's labour cost advantage erodes over time with rising wage rates,

the competitiveness will have to be sustained by internalizing the full value chain. At present a larger part of the value addition takes place out of India in the form of designing, quality control, branding and distribution and logistics. Indian companies could consider acquisition of some Western clothing chains or retailers or intermediaries that perform the task of procurement on behalf of major clothing chains as a part of a strategy to move up the value chain much in the same way as Tata Tea did with the acquisition of Tetley Brands in 2000. A similar move up in value chain is required for the gems and jewellery sector as well as in agricultural and horticultural exports. The acquisitions could be particularly timely in the current context of low stock prices.

India is also in a position of building a leadership in metals given our asset bundles comprising raw material endowments, managerial expertise, and the ability of leading Indian companies to integrate themselves with global champions such as Corus and Novelis. Hopefully the supply chain coordination and restructuring within the respective enterprises will assist the Indian industry move up the value chain over time and expand exports. We should gradually phase out export of raw materials such as iron ore and concentrate on export of value added products.

Building Global Leadership in Modern Industries based on India's Frugal Engineering Capabilities

In recent times, Indian firms have successfully demonstrated their ability to develop cost-effective products especially in a few modern skill-intensive industries such as generic pharmaceuticals, satellites and their launch vehicles, two wheelers, small cars, and indeed the Nano with their "frugal engineering" capabilities (Kumar 2008). In generic pharmaceuticals, India has emerged as a leader in supply of cost-effective life saving drugs. Indian companies will need to expand their footprints globally to secure markets and build worldwide distribution channels. Acquisition based strategy adopted by some Indian companies over the past few years can be helpful in jumpstarting global expansion. Indian

companies also need to innovate new drug delivery systems, if not new molecules, to keep their edge in a highly price competitive generics space.

In compact automobiles, the advantage of India emanates from its large domestic market and the ability of Indian companies to develop low cost products such as the Nano. With the rising fuel prices small, fuel efficient vehicles will have a huge and growing market worldwide. We need to build a strong presence in this sector. For this the leading companies should employ a combination of strategies including marketing tie-ups in different markets, strategic alliances, licensing arrangements besides acquisitions. The interest generated by Tata's Nano worldwide should be capitalized on for building a global presence. At last we have a product innovation for the global market and it should be used to build a global leadership position in compact cars. We need to do a Nano to the two wheelers which will cater to another set of millions who ride bicycles every day. A huge opportunity is waiting to be exploited.

While the mobile handset making industry in the country has taken off, somehow we have not been able to build a large consumer electronics and PCs manufacturing base despite our large domestic market, skill base and strengths in software development and embedded software development capabilities. A product innovation of the Nano variety could help in developing a major industry for feeding a large demand at home and in other developing countries.

Assisting Corporate Innovative Activity to Move up the Value Chains

For moving up the value chain, most important challenge will be the ability of Indian companies to innovate in product development and process development spaces. As we move up the value chain the importance of innovation-based rivalry will become increasingly critical. It is extremely important to strengthen India's national innovation system especially the enterprise-level technological effort. Given the market failures resulting from spillovers of knowledge, R&D activity will

generally be underfunded by the markets. Hence, governments in the US and the EU extensively subsidize enterprise-level R&D activity as a part of strategic trade policy. Unlike other subsidies, R&D subsidies up to 50 per cent of cost are consistent with WTO regulations. It is time that India begins supporting corporate R&D as a part of strengthening international competitiveness, especially of SMEs.

Exploiting the Potential of FDI for Export-Oriented Production

The potential of FDI for fostering export-oriented industrialisation like China among other East Asia countries remains to be exploited. Studies have shown that a selective approach and performance requirements may be helpful (see Kumar 2002 for evidence). The experience from several developing countries suggests that such performance requirements can be effective instruments for developing linkages with global supply chains (Kumar 2003). In India, the growth of auto component exports from virtually scratch to nearly US$ 4 billions over the past few years owes largely to the foreign exchange neutrality condition that used to be imposed on foreign auto producers among other consumer goods industries during the 1990s. It pushed Ford, among other auto majors, to recognize the potential of Indian component vendors and incorporate them in their global sourcing strategies.

The policy towards FDI in retail, for instance, can try to maximize the gains from foreign entry while minimizing the threats by insisting on certain performance requirements such as joint venture requirements and export performance requirements. The joint venture requirement will assist in absorption of technology brought by their local partners. The export performance requirements will encourage foreign retailers to procure from India for their other markets through their global procurement chains. The export performance requirement imposed on retail FDI in the form of say 25-50 per cent of sales, depending upon the extent of foreign ownership, could push the foreign retailers to procure a growing quantity from the country as their domestic sales expand. There is a huge

potential for foreign retailers working with Indian SMEs, as they do globally, to develop private label goods, to upgrade their products and packaging requirements to global standards and procuring them for their Indian as well as global operations. Walmart alone procures over US$ 15 billion worth of goods in China annually. Such requirements are fully consistent with our obligations under WTO's General Agreement in Trade in Services (GATS) and Trade Related Investment Measures (TRIMs) Agreement. Such requirements will also help offset their imports and other remittances that their operations in India may entail. Government may employ additional requirements such as on minimum floor space per outlet to confine them outside thickly populated areas to minimize the competition with unorganised retail. It could also provide access to cheaper credit and assist them in creating self-help groups to develop and manage supply chains for them.

Moderating FII Inflows

Another lesson that needs to be taken from the trends of the past years includes the need for moderation of FII inflows. Volatility of FII inflows over the past years has caused wide variations in the exchange rate of the rupee, creating hardships for exporters besides bringing wild fluctuations in the stock market indices. These flows are also very expensive in terms of their servicing burden vis-à-vis other capital flows such as FDI, NRI deposits and external commercial borrowings. The government should impose curbs on these flows in the form of reserve requirements and higher transactions tax. On the other hand FDI inflows and NRI deposits can be promoted to augment the foreign exchange reserves and investment requirements.

Coordination of Industrial, Export Promotion, Employment Generation and Regional Development Policies

We need to coordinate the industrial, export promotion, employment generation and regional development policies to enhance their effectiveness and to minimize the chances of

contradiction. They need to be looked at together as a wholesome package. The next generation of policies need to pay attention to them as a gamut of objectives. It is possible to combine the employment generation objectives with export promotion (RIS 2006). When these policies are integrated with infrastructure development (social and physical) focusing on the lagging regions, it may be possible to combine all their objectives and achieve more optimal outcomes than if they are pursued in a piece-meal manner.

Deepening Regional Economic Integration in Asia

Although India's trade with East Asia has grown and East Asia has emerged as the largest trading partner of India but we have not fully exploited the East Asian markets for our exports. As a result, India's imports from the region are much larger compared to its exports to the region. As a result, a large proportion of our trade deficit is originating in East Asia. We need to pay attention to expanding exports to the East Asian countries, especially in the context of the financial crisis as these economies are still having good growth and our penetration levels are very low especially in manufactured exports. So in the next few years, these are the markets we have to concentrate on.

In terms of trade policy priorities, while we should continue to actively participate in the WTO negotiations to bring down the high peak tariffs on labour-intensive goods in developed countries, bilateral and regional trade negotiations should be employed to secure preferential access to important markets. In that context, it is of utmost importance that we are part of the emerging regional trade bloc in East Asia. Combining three of the four largest economies of the world, an East Asia Summit (or ASEAN+6) based regional trade arrangement has the potential to emerge as a centre of gravity in the world economy. India, therefore, should work actively towards building a regional trade arrangement in East Asia, which could evolve into a pan-Asian economic community over time. Combining three of the four largest economies of the world, an East Asia Summit-based regional trade arrangement has the potential

to emerge as a centre of gravity in the world economy. India, therefore, should work actively towards building a regional trade arrangement in East Asia, which could evolve into a pan-Asian economic community over time. The leaders of EAS have already launched a track-II study on a Comprehensive Economic Partnership of East Asia (CEPEA) which could become a framework for regional cooperation and integration in the Asian region, bringing together the sixteen most dynamic and largest economies of the continent (see Kumar *et al.* eds, 2008 for more details).

An Asian Financial Architecture for Financial Cooperation

Asian countries have accumulated over US$ 4 trillion of foreign exchange reserves that need to be deployed outside the region, also in low yielding US treasury bills as Asia lacks a regional mechanism for their fruitful deployment. Asia desperately needs a mechanism for generating additional demand to moderate the effect of global slow down for sustaining its dynamism. In the wake of the 1997 East Asian crisis, Japan had proposed Asian monetary fund as a regional lender of last resort but abandoned the idea under Western resistance. Eventually a more modest Chiang-Mai Initiative (CMI) was launched by ten ASEAN countries and China, Japan and South Korea (ASEAN+3) to provide liquidity assistance to countries in difficulty through a system of bilateral swaps. Subsequently, these bilateral swaps have been multilateralized into a pool of about US$ 80 billion of which only 20 per cent can be drawn without invoking IMF's conditionalities. However, there are many limitations to this arrangement. First, the size of the pool is small especially that without conditionality. In today's world, bail out packages for financial crises run into hundreds of billions of dollars. Second, CMI is limited to only response to crisis and not generation of additional demand. It may be of limited use for the current crisis which is impacting the region through demand recession. Third, it is not inclusive, being limited to the crisis affected countries and Japan in the 1997 crisis.

In the current context a more profound and bolder approach needs to be considered. A bolder approach is now

feasible given their sizeable reserves. The management of these reserves is a problem for the region's governments and are mostly invested in US treasury bills in the absence of a regional mechanism for their productive deployment. As a result, many governments are setting up sovereign wealth funds to manage their foreign exchange reserves. China has set up such a fund of $ 200 billion. Again these funds only chase good returns from investments in the existing assets and do not create any new demand.

RIS has developed a proposal for creating a regional mechanism (call it Reserve Bank of Asia, RBA or by another name) that will draw upon a very small part of the foreign exchange reserves of the region (RIS 2007; Agarwala 2008). Given the size of the region's forex reserves, even their modest 5 per cent will create a pool of US$ 200 billion. RBA would be able to borrow from the region's central banks at the prevailing rates of US treasury bills. Besides providing balance of payment support to the member countries in the period of crisis, RBA would invest and co-finance infrastructure projects—national as well as cross-border—in the region. RBA could also provide for a basis for launching a unit of account, namely, Asian currency unit (ACU) for facilitating intraregional trade by moderating the exchange rate volatility between region's currencies. It would evolve its own set of conditionalities that are development-friendly rather than now discredited IMF's conditionalities. With a large capital base, RBA would have the potential of catalyzing billions of dollars of additional investments in the region, not only generating demand to moderate the effect of the current crisis but also expediting the development of the region, improving the connectivity and bridging the development gaps between and within the countries. One regional platform that is especially relevant for launching an initiative such as this is the East Asia Summit. Launched in 2005 with the participation of leaders ten ASEAN countries—Japan, China, South Korea, India, Australia and New Zealand—EAS is an annual forum for dialogue on regional cooperation related issues. It has already identified finance as an area of cooperation. Hence, it could become an

ideal forum to create an Asian financial architecture. India has much to contribute to financial cooperation in Asia. While we face a challenge of management of our foreign exchange reserves, we are also seeking US$ 500 billion for investment in infrastructure development. With the global crisis, it would be difficult to raise resources of that order for our needs. RBA could facilitate flow of funds to the country among other sources. It goes without saying that with an approach to financial cooperation such as this, Asia will also be able to play its due role in shaping the global financial architecture. India should take it up at the next meeting of the EAS, among other responses to the financial crisis.

Reform of International Financial Architecture

It is clear that emerging countries such as India have a stake in global financial architecture. They are among the worst affected ones without any mismanagement of their own given their exposure to FIIs. Despite being among the worst affected ones, the emerging economies are pulling the growth of the world economy now, and have emerged as the new locomotives of the world economy, as the G-3 economies are shrinking. So their voice on the reform of financial architecture should be heard. They should have a key role to play in the new global financial architecture and in framing the rules that are needed to ensure that this kind of crisis does not recur. In the context of the discussion on various proposals going on in the G-20, among other issues, there is need to consider an international Tobin tax to moderate short-term capital flows and the FIIs which bring volatility, and the issue of an international reserve currency for stimulating the world economy.

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To sum up, therefore, the time has come for taking bold steps to revive the growth momentum of the Indian economy in the wake of the worst crisis of the world economy since the Great Depression. India should seize the moment before it is too late

to inject a stimulus by building an all party consensus in national interest while enhancing the inclusiveness of the growth process. It should also pay attention to worsening balance of payments situation especially by leveraging the large domestic demand for a number of new products to build new industries, consolidate India's presence and move up the value chain in existing export products through outward investments, export-oriented FDI and supporting innovative activity of Indian enterprises. India should further deepen its engagement with East Asian countries in view of their emergence as the growth locomotives and centres of gravity of the world economy to build an Asian integrated market and community. There are also real opportunities for financial cooperation designed to exploit the Asian countries' foreign exchange reserves for development of infrastructure in countries such as India and revive demand besides meeting the balance of payment problems and facilitating intra-regional trade. Finally, the voice of emerging countries in Asia such as India should be heard in the reform of international financial architecture in view of their stake in the system and their emergence as the new growth drivers of the world economy.

9

Comments on the Review by the Discussants

Pinaki Chakraborty*

This Mid-Year Review (MYR) of the India Economy has been presented in exceptionally difficult economic circumstances. The uncertain economic environment hit by the global financial crisis and its likely impact on India and the strategies needed to combat them is the main thesis of the Review by Dr. Nagesh Kumar. The author has critically evaluated the policies undertaken and options available with the government to counter the crisis. The real question one has to grapple with is how long this recessionary phase in the US and Europe will continue and how that is going to impact directly and indirectly the developing world, especially the emerging market economies like India.

The author pointed out that the government is optimistic about the growth prospect of the economy for 2009-10 and beyond due to the various short and long-term measures taken by the government and also due to the decline in the oil prices. He pointed out that short-term measures are easing the liquidity condition and fiscal expansion due to the 6th Pay Commission's recommendations, stimulus packages, and so on. The long-term outlook is the headroom for enhancing savings rate, increase in physical and social infrastructure, export, FDI, demographic dividend and the potential for productivity gains.

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The most important question in this context is how strong are the macroeconomic fundamentals of the Indian economy and whether the policies initiated by the government are sufficient to deal with the crisis. So far as macroeconomic fundamentals are concerned, it must be noted that with the decline in global crude prices, the inflation rate is on the decline; the fall in the oil prices should reduce the import bill; the savings rate is high and there is no crisis of confidence in our financial system with regard to the availability of fund. Given these fundamentals, some important observations in the MYR may be worth highlighting:

- Need for geographical diversification of trade and less dependence on advanced countries for export.
- Increase in the FDI flows, but lot needs to be done to improve the quality of FDI
- Share of FDI in total Foreign capital inflow should increase to reduce volatility
- Liquidity needs to be maintained and credit should be available to the productive sectors of the economy in the short and medium term

However, the author pointed out that the scope for fiscal stimulus at this time may be more. Also as the government has an improved fiscal balance in the last few years, even if the deficit goes up due to higher fiscal expansion, it will not be as high as it was during the 1990s. But the concern is whether fiscal stimulus would invariably increase the deficit. One needs to see how this additional deficit is going to be financed. Government should try alternatives in such a way that pressure of borrowing does not fall entirely on the market borrowing, which may increase the interest rate. Given the combinations of borrowing options, a moderate level of monetisation without compromising monetary stability may be considered. But there is a need for a strict control on revenue deficit, which is difficult with the implementation of the 6th Pay Commission recommendations.

Also there are concerns which are required to be addressed with urgency but these are absent in the MYR. Most

importantly, the post reform regional inequality has increased in India as some of the states have been able to reap the benefits of reform better. By the same logic, the global economic slowdown would also affect the state economy and the impact would be different in different states depending on how the state economy is integrated with the global economy. So at this hour we need to have policies designed to tackle the spatial inequality and the crisis-induced impact on the state economy.

Also with the possibility of a sluggishness of central revenues, we may have problems more on those states with larger dependence on central revenues. With the state level Fiscal Responsibility Act in place, which ensures hard budget constraints quite effectively, there is a need to make sufficient resources available for provisioning of public services in those states which are lagging. As revenue growth will be sluggish at both the central and the state level, there is a big question mark on how the problem of resources could be tackled at the state level. If not, this is bound to create further bottlenecks for both social and physical infrastructure and thereby overall economic growth

Finally, although in the MYR there is a cautious optimism in growth front, that would depend on many factors, primarily the ease in liquidity in the system, lower interest rates and availability of credit to the productive sectors. However, we also need to see that fiscal stimulus is directed in a manner that ensures a growth not driven by current consumption and other committed expenditures. Reforms should not be delayed in critical areas, especially fiscal reforms like GST, which will be revenue enhancing. Issue of regional inequality should be addressed with urgency. The fiscal stimulus should pay attention to how the provisioning of infrastructure could be increased in backward and lagging regions. Finally, one should use this crisis as an opportunity to push public investment in critical areas and that in turn should increase private investment. Also, as states spend roughly half of the total government expenditure, they should also be given greater flexibility to spend.

M.K.Venu*

GDP growth in 2008-09 could be over 6 per cent, largely because the first six months of 2008-09 saw GDP grow at 7.8 per cent. There existed a growth momentum in this period. The global financial meltdown and the precipitous real economy decline in the developed world began in the second half of 2008-09. Therefore, 2009-10 could see a marginally lower GDP growth than 2008-09 for India. This is largely because the OECD economies are not likely to return to positive growth in 2009.

India's exports, including those of services, are close to 20 per cent of the GDP and much of this goes to the OECD countries. To that extent a delay in the recovery in the OECD will impact India's GDP. Though India does have a relatively high domestically driven growth potential, compared to other emerging economies, it could therefore manage close to 6 per cent GDP growth in 2009-10.

The other big point is that India's Balance of Payment (BoP) situation was relatively stable and strong. In relative terms India will continue to attract foreign capital due to its inherent ability to provide long-term growth and returns. Once the United States starts dropping interest rates to near zero India will automatically become more attractive to global capital as real and nominal interest rates are higher here. It is not the FII portfolio fund withdrawals which were the main cause of falling forex reserves. Substantial fall in reserves were due to relative changes in value of currencies which constitute the RBI's forex reserves. An appreciation in the dollar against other key currencies reduces the dollar value of the reserves because a substantial amount of reserves are kept in non-dollar denominated currencies.

As for the BoP situation the current account deficit will soften considerably, to about 2 per cent of the GDP, following the collapse of oil prices and other commodities. This will easily be funded by capital flows and existing reserves. As for external debt, about $85 billion of debt was coming up for repayment

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in 2009. This had been a cause of worry initially. More than half of this was constituted by liablities on account of maturing NRI deposits with Indian banks and short-term trade credit by PSU oil companies to buy crude when oil prices were ruling at over $140 per barrel. NRIs continue to repose faith in India and in fact data shows they are renewing their deposits and indeed shifting more deposits with Indian banks. As for short-term credit for oil purchases, the problem has resolved itself with the dramatic fall in oil prices over the last six months.

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This year's Mid-Year Review of the Indian Economy is undertaken against the backdrop of the most serious financial crisis the world economy has faced since the Great Depression of the 1930s.

The author examines the outlook for 2008/09 and beyond for the Indian economy in the context of the deteriorating external environment. He also discusses important issues of quality of growth, policy challenges in respect of inflation and fiscal consolidation, trade and balance of payments, capital flows and their quality, among others, ending with policy lessons to moderate the impact of the crisis on the Indian economy and to turn the challenges into opportunities.

The author argues that the time has come for taking bold steps to revive the growth momentum. India should seize the moment before it is too late. It should deepen further its engagement with East Asian countries in view of their emergence as the growth locomotives and centres of gravity of the world economy, to build an Asian integrated market and community. There are real opportunities for India for financial cooperation with the Asian countries.

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