Indian Economy: Current Status and Select Issues*

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I am thankful to Professor Radhakrishna for giving me the opportunity to be here for the release of India Development Report 2004-05. The Report prepared by IGIDR, released today, is unique in several respects. It addresses contemporary policy issues unambiguously and is more issue-based than technique oriented. At the same time, it is based on thorough research with scholarly inputs. Being issue-oriented, the Report captures both macro and micro aspects, especially the institutional aspects of development and human welfare. While being highly analytical, drawing on theory, the Report has no ideological biases and one should be delighted to note the India-centric nature of the policy prescriptions. This Report is special in the sense that it lays significant emphasis on welfare and the social sector. I have no hesitation in strongly recommending this Report to students and scholars alike and to the policy makers and analysts as well. No doubt, there are some areas where the observations in the Report do not fully conform to the policies being pursued by RBI, but such differences in approach do help fine tune the policies better; though most of the differences arise from the assumptions made: the assessment of risks in alternate paths, weights to be attached to relevant factors, operational feasibility contingent upon the political economy, the institutional considerations, *etc.* So, let me compliment all the authors, and in particular Dr. Parikh and Dr. Radhakrishna for this illuminating volume.

I will take the opportunity, not to comment on the Report which is highly recommended for detailed reading, but to supplement it with a few remarks on current status of the economy and refer to select issues.

On October 26, 2004, we set out in the Mid-Term Review of Annual Policy Statement for the year 2004-05 that the overall GDP growth for the year 2004-05 would be in the range of 6.0 to 6.5 percent. Subsequent developments indicate that while monsoon conditions and sharper rise in oil prices had a moderating effect on growth, the manufacturing sector and exports have been performing better than expected. With the economy growing at 7.4 percent in the first quarter and 6.6 percent in the second, the GDP growth in the first half of the year works out to be about 7.0 percent. Unless there are totally unexpected shocks, inspite of some adverse impact of Tsunami which is localised, the projected GDP growth for the year in the range of 6.0 to 6.5 percent should materialise comfortably.

In response to the impact of Tsunami, RBI has adopted a three-track approach. First, ensuring supply of currency, banking services with relaxations in procedures, as appropriate, liberal provision and restructuring of credit for consumption as also resuming productive activities, finance for rebuilding houses and coordinating with state governments, NABARD, NHB and commercial banks. This process is still underway and the RBI's Task Force constituted for the purpose is directly in communication with over 40 branches of commercial banks catering to the affected areas. Second, monitoring of financial markets, which remain largely unaffected. Third, assessing the impact which indicates enormous human suffering and considerable localised loss of assets in both public and household sector but with marginal impact on overall growth and the external sector and manageable additional expenditure in the Central and State budgets.

The Mid-Term Review devoted considerable attention to issues relating to price stability and inflation expectations. The WPI inflation, on a year-to-year basis decelerated to 6.4 percent during week ended December 25, 2004. In view of several uncertainties and the fact that all indirect effects of increases in oil prices domestically are yet to be fully transmitted, the projection at around 6.5 percent made in the Review, continues to be valid. CPI (Industrial workers) inflation, year-on-year, rose to 4.2 percent in November 2004 from 3.1 percent a year ago. In this regard, it is necessary to reiterate the serious concerns expressed in the Review in regard to price stability and inflation expectations for three reasons. First, inflation is a major problem for the

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poor. Second, stabilising inflation expectations is critical to ensuring enhanced investment activity in the private sector, which is a crucial element of current strategy for growth and welfare. Finally, our economy is now more integrated with the global economy, and hence, maintenance of price stability is critical for ensuring financial stability. In this background, both monetary and fiscal policies give considerable attention to price stability, as part of a growth-oriented strategy. The hard earned gains in this regard could be reversed if there is a perception of dilution in commitment to contain undue inflationary pressures. In assessing the risks of higher inflation it is, therefore, important to capture not only the probability and magnitude of adverse impact of policies on inflation but also the damage that could be done both to price stability and inflation expectations in the event, even with very low probability, the risks do materialise. Hence, there is a need to continue to demonstrate, in a credible fashion, by words and deeds, commitment of both monetary and fiscal authorities to stabilise inflation expectations.

The government finances present a mixed picture since the presentation of the Review, with greater comfort in regard to the Central government's borrowing programme and some discomfort at the trends in revenue deficit relative to Budget Estimates. The conduct of market borrowing programmes of several States continues to be a matter of concern.

A distinguishing feature of the current year has been the strong growth in bank credit. Non-food credit expanded by 18.1 percent in the current financial year upto December 24, 2004. The growth in credit for housing and consumer durables continues to be a matter of some concern to the extent it reflects on credit quality, but a source of comfort is that the overall credit growth of late is reasonably well dispersed across sectors. Though credit growth has shown an uptrend, money supply (M3) growth has remained subdued at 7.2 percent. By and large, the monetary trends are within the projections made in the Review.

The financial markets generally remained stable. Though there was an upward movement in interest rates in money and government securities markets in November, the interest rates have since reverted closer to levels in October 2004. The yield spread between highly rated corporate paper and government securities increased. Furthermore, the spread between long term and short term government securities has declined.

In the credit markets, the benchmark prime lending rates remain generally unchanged though interest rates for housing have marginally firmed up. Public sector banks increased their rates for deposits of over one year.

In the external sector, conditions in our forex market continue to be orderly. Global developments in regard to output growth, currency markets, *etc.* have not been divergent from our expectations in the Review and may continue to be so though uncertainties in regard to oil prices will continue, *albeit* in a muted fashion. Since March 2004 the rupee has tended to appreciate against the US dollar and depreciate against other major currencies, primarily reflecting the weakening of US dollar. There are, however, some developments during the current year which are noteworthy. First, foreign exchange reserves increased by US$18.2 billion, from US$113.0 billion at end March 2004 to US$131.2 billion as at end December 2004. Nearly sixty per cent of the reserve accretion in the current financial year has come in two months (November and December) – perhaps indicative of the volatility in portfolio flows.

Second, the trade deficit on the balance of payments basis doubled to US$12.3 billion in the second quarter from US$5 billion in the first quarter – reflective of surge in imports – both due to increase in oil-prices and pick up in investment activity. There is no reason to believe that the trend will not persist for the rest of the year which may have a potential for a large trade deficit during the year as a whole.

Third, the current account of the balance of payments which was in a surplus of US$3.2 billion in the first quarter turned into a deficit of US$6.4 billion, reflective of not only surge in trade deficit but also moderation in the invisibles surplus. It is, therefore, possible that the current account for the year as a whole may be marginally in deficit or very marginally in surplus. Despite the surge in trade deficit, a strong case for further liberalisation of trade and rationalisation of tariffs persists since the beneficial effects of such liberalisation are evident.

Fourth, the capital account of the balance of payments shows that in the second quarter, external commercial borrowings and short term credit moderated, while there were outflows under banking capital. NRI deposits continued to register net outflows. Overall, however, the current trends do point to continued surpluses in balance of payments, with possible marginal deficit in the current account being more than compensated by continued strong inflows, particularly on account of inflows on Foreign Direct Investment (FDI) and Foreign Institutional Investors (FII) flows.

Our emphasis in management of capital account has generally been on external debt as recommended by Rangarajan Committee, more than a decade ago, but there are several reasons, for exploring an appropriately active but nuanced management of non-debt flows at this stage. The magnitudes of FDI/ FII flows are tending to be large and volatility has perhaps increased. The impact of such flows on the stock markets is discernible, but perhaps less evident at this juncture in corporate ownership and control. The possible issues that need to be considered if one were to achieve a better management of non-debt components of capital flows that will address emerging concerns are:

First, a view needs to be taken on the quantity and quality of FII flows. While quotas or ceilings, as practised by certain countries, may not be desirable at this stage, there is merit in our keeping such an option open and exercising it selectively as needed, after due notice to the FIIs.

Second, there is scope for enhancing quality of flows through a review of policies relating to eligibility for registration as FIIs, and assessment of risks involved in flows through hedge funds, participatory notes, sub-accounts, *etc.* Strict adherence to ‘Know Your Investor’ principle, especially in regard to flows from tax-havens, including beneficial ownership would enhance quality.

Third, price-based measures such as taxes could be examined though their effectiveness is arguable and hence may not be desirable.

Fourth, FDI flows, as currently defined, also include transfer of equity from residents to non-residents and a disaggregated analysis of FDI through several routes could enable a policy intervention, as appropriate on quantities and quality.

Fifth, since there are several routes by which non-residents could hold shares and voting power over Indian corporates, reporting and monitoring arrangements could be considered for assessing the aggregate shares of residents (other than government) and non-residents in larger corporates and those in sensitive sectors in particular. Such monitoring could help timely policy-responses on several fronts.

Finally, consistent with the principle of hierarchy of capital flows, a view could be taken on relative policy emphasis on sources and types of investment that need to be encouraged. For example, it is well recognised that giving better incentives to foreign investors over domestic investors results in scope for “round-tripping” and inefficiencies. Similarly, if avenues for portfolio flows or equity-transfers from domestic to foreign investors are easily available and attractive, the flows under FDI defined in terms of adding to domestic production capacities will tend to be smaller. Attention to these may simultaneously address micro or institutional issues relating to corporates, volatility issues relating to capital flows and financial markets, and above all ensure high-quality inflows of foreign savings which is more important to our country at this stage of development, to provide a healthy supplement to the domestic savings.

Ultimately our unswerving objective has to remain a sustained growth rate, moderate inflation and distributive justice, in an atmosphere of overall stability.

It has indeed been a pleasure listening to the illuminating remarks of Dr. Deshpande, Dr. Chandra Mohan, Dr. Narsimha Reddy and Dr. Parikh. Let me conclude by expressing, once again, my deep appreciation of the excellent and pioneering work undertaken by IGIDR on developmental issues.