

Acharya, Shankar

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India's Macroeconomic Performance and Policies since 2000

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Shankar Acharya

October 2008



Contents

Foreword.....	i
Abstract.....	ii
I. Review of Macroeconomic Developments.....	1
A. Growth	1
B. Inflation	3
C. External Balance	5
D. Domestic Balance: Deficits, Savings and Investment	7
E. Macroeconomic Performance: an overview	9
II. Major Challenges for Macroeconomic Policy	10
A. Fiscal Consolidation.....	11
B. Foreign Capital Surge.....	13
III. Key Issues for the Future	17
A. Restoring Fiscal Balance.....	17
B. Convertibility and Exchange Rate Management.....	19
C. Role of the Reserve Bank.....	20
D. Coping with International Uncertainty	21
References.....	23

List of Tables

Table 1: Growth of Real GDP	1
Table 2: Sectoral Composition of Growth.....	2
Table 3: Expenditure Composition of Growth.....	3
Table 4: Inflation Trends	4
Table 5: Balance of Payments Indicators.....	5
Table 6: Consolidated Deficits of Central and State Governments	7
Table 7: Savings and Investment	9
Table 8: Comparative Overview of Macro Indicators	10
Table 9: Deficits of Central and State.....	11
Table 10: Centre's Fiscal Position- A Summary Review.....	12
Table 11: State's Fiscal Position- A Summary Review	13
Table 12: Capital Inflows and Reserves	14

List of Figures

Figure 1: Annual Inflation Rates.....	4
Figure 2: Combined Deficits of Central and State Governments	8
Figure 3: The Impossible Trinity	15
Figure 4A : Annual 6- country NEER and REER indices	16
Figure 4B: Monthly 6- country index of REER.....	16

Foreword

Given the current unsettled economic conditions both globally and in India, this paper is extremely topical. With his insider's view of the macroeconomic situation, Professor Acharya, has expectedly provided a number of analytical insights into India's macroeconomic performance since 2000. Both policy makers and researchers will find the last section on challenges currently facing the Indian economy specially useful. It is my hope that this paper will help focus attention on the need for a better coordination of monetary and fiscal policies for managing the macroeconomic situation. And at the same focus on current challenges also highlights the importance of pressing on with structural reforms. Professor Acharya's working paper has provided the best possible start for future output from ICRIER's macroeconomic unit.



(Rajiv Kumar)
Director & Chief Executive

October 14, 2008

Abstract

The paper reviews India's macroeconomic performance and policies since 2000. The first section briefly summarizes key macroeconomic developments regarding economic growth, inflation, external balance, the fiscal situation and aggregate savings and investment. The second section considers some of the challenges posed to macroeconomic management in this period and the efficacy of the policy responses adopted. In particular, it analyses the progress in fiscal consolidation and the policies adopted to deal with the challenge of the unprecedented surge in external capital inflows into India. The final section outlines some of the major macro policy issues that need to be addressed in the years ahead, including: the resurgence of high fiscal deficits; the issues relating to external convertibility and exchange rate management; the role of the Reserve Bank of India in macroeconomic policy and coping with a weak international economic environment.

***JEL Classification:* E58, E62, F41,F43**

Keywords: Economic growth; inflation; fiscal policy; savings and investment; capital inflows; exchange rate policy; central bank role.

Macroeconomic Performance and Policies since 2000

Shankar Acharya¹

This paper reviews India's macroeconomic performance and policies after 2000 and up through the end the fiscal year 2007/8. Section I provides a brief review of macroeconomic developments since 2000. Section II considers some of the challenges posed to macroeconomic management in this period and the efficacy of the policy responses adopted. The final section outlines some of the major macro policy issues that need to be addressed in the years ahead.

I. Review of Macroeconomic Developments²

A. Growth

The pace of economic growth is usually regarded as the primary indicator of a country's macroeconomic health. By this measure India has done very well in this decade, especially in the most recent five years, with GDP growth averaging an unprecedented 8.8 percent a year over 2003/4-2007/8. The previous best five-year period for growth was in 1992/3-1996/7 (at 6.6 percent a year), triggered by the initial burst of economic reforms following the balance of payments crisis of 1991 (Table 1). That earlier spurt in investment, productivity and growth had faltered after 1996 because of several factors, including: the headwinds from the East Asian financial crisis; the initial uncertainties of coalitional governance; and a sustained deterioration in the fiscal deficit caused primarily by the large public pay increases following the Fifth Pay Commission.³ As a consequence, growth had slowed to an average of 5.5 percent during the Ninth Five Year Plan period, 1997/8-2001/2. It dropped even lower to 3.8 percent in 2002/3 because of a sharp, drought-induced fall in agricultural output.

Table 1: Growth of Real GDP

(Percent per year)

	1992/93- 1996/97	1997/98- 2001/02	2002/03- 2006/07	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07	2007/ 08
GDP(factor Cost)	6.6	5.5	7.8	3.8	8.5	7.5	9.4	9.6	9.0
Agriculture	4.8	2.5	2.5	-7.2	10.0	0.0	5.9	3.8	4.5
Industry	7.3	4.3	9.2	7.1	7.4	10.3	10.1	11.0	8.5
Services	7.3	7.9	9.3	7.5	8.5	9.1	10.3	11.1	10.8
Per capita GDP	4.4	3.5	6.1	2.3	6.9	5.8	7.7	8.1	7.5

Source: CSO.

Note: Industry includes Construction.

¹ I am grateful to Shikha Gupta for expert research assistance.

² For a detailed account of macroeconomic policies and developments in the 1990s see Acharya (2002a).

³ Some, like Surjit Bhalla, stress other reasons for this slowdown, notably unduly restrictive monetary policy in the mid-90s.

Since then we have witnessed an extraordinary boom, with the aggregate investment rate surging above 37 percent of GDP by 2007/8 and economic growth soaring to 9 percent or higher in the last three years, 2005/6-2007/8. The proximate drivers of this growth spurt included the sustained investment boom, cumulative productivity-enhancing effects of reforms, an unusually buoyant international economic environment and a demand-and- technology driven acceleration of modern services output. Inspection of the sectoral composition of growth shows that the Ninth Plan slowdown was confined to agriculture and industry; services continued to grow fast and even accelerated (Table 1). Moreover, the expansion of services accelerated further in the years after 2002/3, propelled by high rates of growth in communications (especially telecom), business services (especially information technology) and finance.⁴ Industry picked up steam from 2002/3 and continued to grow robustly right through to 2007/8. Agricultural growth remained variable, substantially dependent on weather conditions. The sector has been unusually buoyant in the last three years, contributing significantly to the 9 percent plus rate of overall economic growth.

Table 2: Sectoral Composition of Growth

	Share in real GDP (%)		Contribution to GDP Growth (%)		
	Average of 1994-97	Average of 2004-07	1991/92 to 1996/97	1996/97 to 2001/02	2001/02 to 2007/08
Agriculture	28.2	19.4	21.1	11.5	7.0
Industry	26.4	26.5	29.0	20.2	29.3
Services	45.4	54.1	49.8	68.3	63.6
GDP(Factor Cost)	100.0	100.0	100.0	100.0	100.0

Source: CSO.

The exceptionally rapid growth in India's services sector is reflected in the contribution of this sector to overall economic growth since 1991/92 (Table 2). In the five years between 1991/92 and 1996/7 services contributed just about half of total growth in GDP.⁵ In the subsequent five years to 2001/2 the sector's contribution rose sharply to 68 percent and has remained at a high 64 percent in the six years since 2001/2. These shares would be even higher if the construction sub-sector were included under services instead of industry. Perhaps equally noteworthy but more disquieting is the low and declining contribution of agriculture to GDP growth after 1996/7, even though over half of India's labour force is still employed in this sector. In the six years after 2001/2 agriculture contributed only 7 percent of total growth of GDP.

⁴ The extraordinary growth of India's services sector at relatively low income levels has been widely noted and analysed. See, for example, Gordon and Gupta (2004). Doubts have also been raised about the quality of national income estimates in services; see Bosworth, Collins and Virmani (2007) and Acharya (2002a, 2007).

⁵ In the 1980s the contribution of services to overall economic growth was only 46 percent.

Table 3: Expenditure Composition of Growth

	Share in real GDP (%)		Contribution to GDP Growth (%)		
	Average of 1994-97	Average of 2004-07	1991/92 to 1996/97	1996/97 to 2001/02	2001/02 to 2007/08
Investment (GDCF)	23.9	32.6	29.2	20.4	57.3
Government Final Consumption	11.1	10.2	8.2	16.7	5.3
Private Final Consumption	65.7	59.6	54.3	60.2	47.9
Net Exports of Goods and Services (including Discrepancies)	-0.7	-2.4	8.4	2.7	-10.5
GDP(Factor Cost)	100.0	100.0	100.0	100.0	100.0

Source: CSO.

A glance at the composition of GDP growth from the expenditure side is also instructive (Table 3). The increase in aggregate investment expenditure between 1991/92 and 1996/97 accounted for nearly 30 percent of GDP growth achieved during these years and reflected a significant rise in the share of investment in GDP. With the investment ratio declining in the next five years the contribution to growth from investment demand dropped to just 20 percent. However, what is truly remarkable is the surge in investment between 2001/2 and 2007/8, which raised the investment rate above 37 percent of GDP by 2007/8 and contributed an extraordinary 57 percent of total GDP growth over this period. Conversely, the contributions of government and private final consumption expenditure to growth show an opposite pattern, rising in the period between 1996/7 and 2001/2 and falling markedly thereafter.

B. Inflation

If economic growth is the primary indicator of a country's macroeconomic performance, inflation must surely be a close second. Unfortunately, despite recommendations of several expert committees, India does not yet have a nation-wide consumer price index (CPI). It has three separate CPI indices for different categories of workers, of which the one for industrial workers, CPI (IW), is the most commonly cited. The wholesale price index (WPI), published every week, is the most widely monitored indicator of headline inflation. It suffers from the obvious limitation of being confined to commodities in an increasingly services-driven economy. A sub-index of manufactured products, WPI (MP), is sometimes monitored as a proxy for "core" inflation. Against this background the best indicator of inflation over the years may be the implicit GDP deflator. However, it is only available for annual and quarterly data and that too with considerable lags.

Figure 1 and Table 4 present the basic information on annual inflation trends since 1991/92. The data support the following broad generalizations. First, and most importantly, inflation has been in the "comfort zone" of around 5 percent or less in nearly every year since 1998/9. Second, if one focuses on the WPI or five-year

averages of any index, inflation has been subdued since 1996/97 (Table 4).⁶ Third, in the current decade, the GDP deflator has averaged just over 4 percent, with only two years in which the rate has crept above 5 percent. Even in 2007/8 and despite the global commodity price shock which hit India by the first quarter of 2008, the annual rate on inflation reflected in the GDP deflator was only 4.1 percent.⁷

Table 4: Inflation Trends

(Percent per year)

	WPI (AC)	CPI(IW)	WPI(MP)	GDP Deflator
1992/93-1996/97(average)	8.7	9.3	8.3	9.1
1997/98-2001/02(average)	4.9	6.3	3.0	5.0
2002/03-2007/08 (average)	5.0	4.9	4.5	4.4
2002/03	3.4	4.1	2.6	3.8
2003/04	5.5	3.7	5.7	3.4
2004/05	6.5	4.0	6.3	5.5
2005/06	4.4	4.2	3.1	4.1
2006/07	5.7	6.8	4.6	5.5
2007/08	4.6	6.4	4.9	4.1

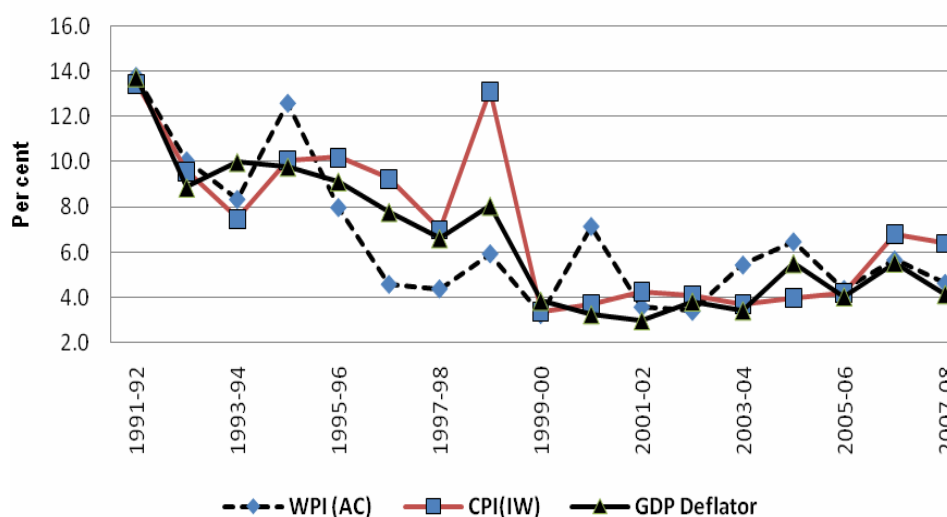
Sources: Reserve Bank of India: Handbook of Statistics on Indian Economy and Bulletins.

WPI (AC) = Wholesale Price Index (All Commodities) 1993/94=100.

CPI (IW) = Consumer Price Index (Industrial Workers) For 1992/93-2006/07, 1993/94=100. For 2007/08, 2001=100.

WPI (MP) = Wholesale Price Index (Manufactured Products) 1993/94=100.

Figure 1: Annual Inflation Rates



⁶ The CPI and GDP deflator spiked upwards in 1998/9 because of a sharp but temporary spurt in vegetable prices (especially onion and potatoes) in 1998.

⁷ Of course, this does not reflect the “suppressed inflation” associated with non-adjustment of officially controlled prices of key petroleum distillates, fertilizers and food grains in the face of sharply rising international prices.

In a nutshell, inflation was not a significant macro policy problem right up until early 2008. The factors contributing to this favorable outcome included: low world inflation (until 2008) combined with increasingly more liberal Indian foreign trade policies; alert and anticipatory monetary policy backed by declining fiscal deficits; and downward revision of inflationary expectations in line with actual outcomes. By March 2008 these factors had turned sharply adverse.

C. External Balance

Usually, the current account balance is the single most widely monitored indicator of a nation's external balance position. In India too, the rise of the current account deficit to a record 3 percent of GDP in 1990/91 preceded the balance of payments crisis of 1991. By this measure, India's external balance position has been comfortable throughout the period 2000/01-2007/8, ranging between a high of 2.3 percent of GDP in 2003/4 and low of *minus* 1.5 percent in 2007/8 (Table 5). Moreover, the relative health of current account balance has been concurrent with a marked rise of India's merchandise trade to GDP ratio from 23 percent in 2000/01 to 35 percent in 2007/8, as the country continued to deepen its integration with world economy and, more recently, rising oil prices bloated the import bill. While this basic assessment is correct, the absence of stress in the current account balance masks some important new trends in the balance of payments.

Table 5: Balance of Payments Indicators

(Percent of GDP at current market prices)

	2000/ 01	2001/ 02	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07	2007/ 08
Merchandise								
Exports	9.9	9.4	10.6	11.1	12.2	13.0	14.0	13.5
Imports	12.6	11.8	12.7	13.3	17.0	19.4	20.9	21.2
Trade balance (A-B)	-2.7	-2.4	-2.1	-2.3	-4.8	-6.4	-6.9	-7.7
Invisibles, net	2.1	3.1	3.4	4.6	4.5	5.2	5.8	6.2
of which								
Software Exports	1.2	1.4	1.7	2.1	2.4	2.8	3.2	3.2
Current Transfers	2.8	3.3	3.3	3.7	3.0	3.1	3.1	3.5
Current Account Balance	-0.6	0.7	1.3	2.3	-0.4	-1.2	-1.1	-1.5
Net Capital Inflows	1.9	1.8	2.1	2.8	4.0	3.1	5.0	9.2
of which								
Foreign Direct Investment	0.7	1.0	0.6	0.4	0.5	0.4	0.9	1.3
Foreign Portfolio Investment	0.6	0.4	0.2	1.9	1.3	1.5	0.8	2.5
External Assistance	0.1	0.2	-0.6	-0.5	0.3	0.2	0.2	0.2
External Commercial Borrowing	0.9	-0.3	-0.3	-0.5	0.7	0.3	1.8	1.9
NRI Deposits	0.5	0.6	0.6	0.6	-0.1	0.3	0.5	0.0
Short Term Trade Credit	0.1	-0.2	0.2	0.2	0.5	0.5	0.7	1.5

	2000/ 01	2001/ 02	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07	2007/ 08
Memo Items								
Foreign Exchange Reserves (year end US \$ billion)	42.3	54.1	76.1	113.0	141.5	151.6	199.2	309.7
Increase in Reserves (US \$ billion)	4.3	11.8	22.0	36.9	28.6	10.1	47.6	110.5
Net Capital Inflows (US \$ billion)	8.8	8.6	10.8	16.7	28.0	25.5	45.8	108.0
Non Oil Export Growth (%)	16.1	-2.3	20.2	20.2	27.0	19.5	17.8	24.5
Non Oil Import Growth (%)	-5.9	7.2	17.0	31.5	41.8	28.8	22.2	24.4
Services Export Growth (%)	3.6	5.4	21.1	29.4	61.0	33.3	32.1	15.1
Oil Imports (US \$ billion)	15.7	14.0	17.6	20.6	29.8	44.0	57.1	79.6
Exchange Rate (Rs/US \$)	45.7	47.7	48.4	46.0	44.9	44.3	45.3	40.2

Sources: Reserve Bank of India: Handbook of Statistics on Indian Economy and Bulletins.

First, the growth of service exports has been strong throughout the period, especially of IT software. Software exports increased more than six fold from \$ 5.7 billion in 2000/01 to \$ 37 billion in 2007/8, raising their ratio to GDP from 1.2 percent to 3.2 percent. Combined with continued buoyancy in current transfers (remittances from abroad), which generally remained above 3 percent of GDP throughout, the ratio of “net invisibles” to GDP tripled from 2.1 percent in 2000/01 to 6.2 percent in 2007/8. It was this robust growth in invisible earnings which took the current account balance into unfamiliar (for India) positive territory for three successive years, 2001/2-2003/4. After that, rapid growth of non-oil imports (sucked in by the investment-led growth spurt) and a steadily rising oil import bill took the current account back into deficit. This is the second noteworthy trend: between 2003/4 and 2007/8 India’s merchandise trade deficit to GDP ratio rose steeply from 2.3 percent to 7.7 percent. And this happened despite strong growth of exports, averaging over 20 percent a year in dollar terms. Indeed, the current account deficit ratio remained moderate thanks only to sustained increase in net invisibles, noted earlier.

The third major development has been on the capital account of the balance of payments. From 2002/3 to 2007/8 India experienced a sustained and unprecedented surge in net foreign capital inflows, which soared tenfold from \$ 10.8 billion in 2002/3 to \$ 108 billion in 2007/8. As a proportion of GDP the increase was from 2.1 percent of GDP to 9.2 percent. The surge was particularly strong in the two years between 2005/6 and 2007/8, when net inflows jumped fourfold from \$ 25 billion to \$ 108 billion. Since over the period 2002/3 to 2007/8 the current account was close to balance, the bulk of the net inflows went to swell the country’s foreign exchange reserves. These reserves rose from \$ 76 billion in March 2003 to \$ 310 billion in March 2008, with nearly \$ 160 billion being added in the last two years. The main forms of capital inflow were foreign direct and portfolio investment and external commercial borrowing by Indian companies. The capital surge and the resultant reserves build-up posed major challenges and choices for the country’s

macroeconomic policies, especially in regard to the exchange rate, convertibility and monetary policies. These are discussed in section II below.

D. Domestic Balance: Deficits, Savings and Investment

Growth, inflation and external balance are the main *ultimate* targets of macroeconomic policy. They are the outcome variables by which an economy's macroeconomic performance is generally evaluated. There is also much interest in a set of *intermediate* target variables which are crucial for macroeconomic policies and outcomes. These are the fiscal balance, savings and investment.

On a combined basis (central and state governments) India has been running large fiscal deficits for over 30 years. Until recently, in any given year, India's fiscal deficit would typically figure among the top seven or eight countries in the world.⁸ As Table 6 and Figure 2 show, the combined fiscal deficit had climbed above 9 percent of GDP in the years preceding the 1991 economic crisis. Rising fiscal profligacy was generally seen as an important contributory factor to that crisis.⁹ Concerted efforts by the central government brought the deficit down to a manageable 6.5 percent of GDP by the mid-1990s. This consolidation was reversed in the next five years because of the large public pay increases after 1996/7, low revenue buoyancy and weak expenditure control policies. By 2001/2 the fiscal deficit was nearly 10 percent of GDP, and the revenue deficit (approximately government dissavings) was at a record 7 percent.

Table 6: Consolidated Deficits of Central and State Governments

(As Percentage to GDP at current market prices)

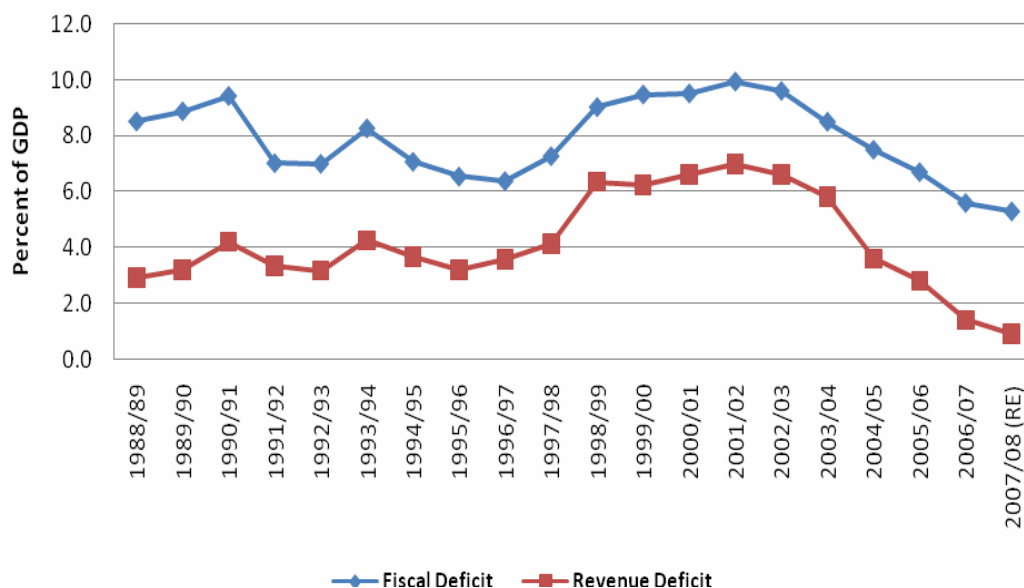
	Fiscal Deficit	Revenue Deficit	Primary Deficit
1988/89- 1990/91 (Average)	8.9	3.4	4.8
1995/96- 1996/97 (Average)	6.5	3.4	1.4
1998/99- 2000/01 (Average)	9.3	6.4	3.7
2001/02	9.9	7.0	3.7
2002/03	9.6	6.6	3.1
2003/04	8.5	5.8	2.1
2004/05	7.5	3.6	1.3
2005/06	6.7	2.8	1.0
2006/07	5.6	1.4	0.0
2007/08 (RE)	5.3	0.9	-0.3

Sources: Reserve Bank of India: Handbook of Statistics on Indian Economy and Annual Report, 2007/08.

⁸ For example, in 2000 India was clubbed with Ethiopia, Turkey and Zimbabwe for the top four slots (Acharya, 2002a).

⁹ See, for example Ahluwalia (2002), Acharya (2002a) and Panagariya (2008).

Figure 2: Combined Deficits of Central and State Governments



A sustained effort at fiscal consolidation resumed after 2002/3 and brought the combined fiscal deficit down to 5 percent of GDP in 2007/8 and the revenue deficit to just one percent (discussed further in section II below). Large fiscal deficits tend to preempt loanable funds, foster high real interest rates and crowd out productive investment. Not coincidentally, periods of declining fiscal deficit have been associated with acceleration in economic growth (1992-97 and 2003-2008), while periods of rising deficits correlate with slowdowns (1997-2002 and, perhaps, 2008-onwards).

The last 6 years, 2002/3-2007/8, have witnessed a remarkable transformation in the level and composition of aggregate savings and investment in the economy (Table 7). First, the total investment rate hardly changed between the early 1990s and the first years of the current decade, holding steady at about 24 percent of GDP. In the next five years it rose steeply to 36 percent in 2006/7 (according to the government's provisional estimates the level rose further to 37.5 percent in 2007/8). Second, this unprecedented jump in the aggregate investment rate by 12 percent of GDP in five years was matched by an almost equal spurt in domestic savings from 23.6 percent of GDP in 2000-02 to 34.8 percent in 2006/7. Third, India has had very little recourse to net foreign savings (equivalent to the current account deficit on the balance of payments) throughout the entire period, especially in the present decade.

Table 7: Savings and Investment*(As percent of GDP at current market prices)*

	1990- 92	1995- 97	2000- 02	2002- 03	2003- 04	2004- 05	2005- 06	2006- 07	2007- 08
1. Household Savings	17.1	16.4	21.9	23.2	24.4	23.0	24.2	23.8	
2. Private Corporate Savings	2.9	4.7	3.6	3.9	4.4	6.6	7.5	7.8	
3. Public Savings	2.2	2.4	-1.9	-0.6	1.1	2.2	2.6	3.2	
(a) Government Administration	-(1.5)	-(1.6)	-(5.8)	-(5.2)	-(3.6)	-(2.6)	-(1.9)	-(1.3)	
(b) Public Enterprises	(3.7)	(4.0)	(3.9)	(4.6)	(4.7)	(4.8)	(4.5)	(4.6)	
4. Gross Domestic Savings (1+2+3)	22.2	23.6	23.6	26.4	29.8	31.8	34.3	34.8	
5. Net Foreign Savings	1.9	1.5	0.0	-1.2	-1.6	0.4	1.2	1.1	
6. Gross Domestic Investment (4+5)	24.0	25.1	23.6	25.2	28.2	32.2	35.5	35.9	37.5

Source: CSO.

The composition of the massive rise in domestic savings is also quite novel for India. The category of “households” (including unincorporated enterprises) continues as the largest single component of domestic savings, with its share rising steadily as a ratio of GDP over the past two decades. But this category of savers only accounted for an additional 2 percent of GDP between 2000-02 and 2006/7. The remainder of the 11 percent (of GDP) increase came from private companies and the public sector (government and enterprises). The contribution of private corporate savings (depreciation provisions and retained earnings) more than doubled from 3.6 percent of GDP in 2000-02 to 7.8 percent in 2006/7. This remarkable increase was propelled by the extraordinary growth in corporate earnings after 2003/4 and the surge in corporate investment from under 6 percent of GDP in 2000-02 to 14 percent in 2006/7.

But the biggest contributor to the savings explosion after 2001/2 has been public savings, which went from *minus* 1.9 percent of GDP in 2000-02 to *plus* 3.2 percent in 2006/7, a massive turnaround of 5.3 percent of GDP. As Table 7 shows, the bulk of this improvement occurred in government (at all levels), with only modest increases in the enterprise sub-sector. Basically, the turnaround was driven by reductions in revenue deficits of central and state governments during this period (for reasons elaborated in section II). In a nutshell, the huge 12 percent of GDP rise in the gross investment rate over the last six years was largely funded by unprecedented increases in corporate and government savings.

E. Macroeconomic Performance: an overview

By 2007/8, sixteen years had passed since the external payments crisis of 1991/92 and the initial burst of economic reforms it triggered. It is instructive to look at how major macroeconomic indicators have evolved over this period. Table 8 presents the data for three successive sub-periods, with the first two corresponding neatly to the Eighth and Ninth Five Year Plans and the third period spanning the Tenth Plan plus the year

2007/8. The data reveal a striking fact: all the macroeconomic indicators show superior outcomes in 2002/3-2007/8 as compared to the earlier sub-periods, with the marginal exception of the combined fiscal deficit, which is very slightly higher in 2002/3-2007/8 as compared to 1992/3-1996/7. Indeed if we shorten the latest sub-period to five years by dropping 2002/3, then even this marginal qualification vanishes (see the last column in Table 8).

Table 8: Comparative Overview of Macro Indicators

	(1)	(2)	(3)	(4)
	1992/93- 1996/97	1997/98- 2001/02	2002/03- 2007/08	2003/04- 2007/08
Economic Growth (% per year)	6.6	5.5	7.9	8.8
Inflation (GDP deflator, % per year)	9.1	5.0	4.4	4.5
Current Account Deficit (% of GDP)	1.1	0.6	0.1	0.4
Combined Fiscal Deficit (% of GDP)	7.1	9.0	7.2	6.7
Gross Domestic Investment (% of GDP)	24.2	24.3	32.2	33.6

Sources: Tables 1, 4, 5, 6, 7.

In other words, the latest five-year period, 2003/4-2007/8 boasts the best average outcomes with regard to all the major macro indicators of economic growth, inflation, external balance, fiscal imbalance and aggregate investment, when compared to any other five-year period since 1991. Furthermore, this superiority in macroeconomic performance would hold up on all counts, even if we took such comparisons back to 1980.

Before we succumb to excessive complacency, it is important to note that the combination of a global slowdown, a world-wide commodity price shock (especially energy and food), stalled domestic economic reforms and fiscal laxity seem to have marked 2008 as the end of this “golden era”, with economic growth slowing, inflation soaring, the current account and fiscal deficits widening sharply and gross investment faltering. Put another way, the legacy of 2003/4-2007/8 is a set of very difficult macroeconomic challenges for the country. More on this in section III.

II. Major Challenges for Macroeconomic Policy

The period 2001-08 began with massive fiscal deficits at central and state government levels and ended with an inflationary spurt induced by an unforeseen global commodity price shock. In between, there were other major challenges for macro policy, including a sustained surge in foreign capital inflows after 2002/3 and an unprecedented acceleration in overall economic growth. This section focuses on two of these major issues: fiscal consolidation and the external capital surge.

A. Fiscal Consolidation

By 2001/2, the combined fiscal and revenue deficits of the central and state governments had attained record levels of 9.9 percent and 7 percent of GDP, respectively. Growth had slowed and aggregate savings and investment ratios had dropped markedly from earlier peaks. Government dissavings had risen to an unprecedented 6 percent of GDP and dragged public savings down to *minus* 2 percent of GDP. The growing need for fiscal consolidation had become urgent.

Fortunately, both central and state governments had grasped the gravity of the fiscal imbalance and begun to take effective action. As Table 9 shows, the centre's fiscal deficit declined from 6.2 percent of GDP in 2001/2 to 3.1 percent in 2007/8, while the revenue deficit fell from 4.4 percent to 1.4 percent. Over the same period, the states' fiscal deficit came down from 4.2 percent of GDP to 2.3 percent and the revenue deficit showed an even greater improvement from 2.6 percent of GDP to *minus* 0.5 percent. Together, these changes brought about the marked improvements in the combined fiscal and revenue deficits noted earlier. It is a heartening fact that these crucial improvements in the fiscal position were overseen by two successive governments at the centre (the NDA government until May 2004 and the UPA government thereafter) and a wide variety (politically) of governments at the level of the different states.

Table 9: Deficits of Central and State

(As Percentage of GDP at current market prices)

	Centre		States		Combined	
	Fiscal Deficit	Revenue Deficit	Fiscal Deficit	Revenue Deficit	Fiscal Deficit	Revenue Deficit
2001/02	6.2	4.4	4.2	2.6	9.9	7.0
2002/03	5.9	4.4	4.1	2.3	9.6	6.6
2003/04	4.5	3.6	4.4	2.3	8.5	5.8
2004/05	4.0	2.5	3.4	1.2	7.5	3.6
2005/06	4.1	2.6	2.5	0.2	6.7	2.8
2006/07	3.5	1.9	1.9	-0.6	5.6	1.4
2007/08 (RE)	3.1	1.4	2.3	-0.5	5.3	0.9

Sources: Reserve Bank of India: Handbook of Statistics on Indian Economy and Annual Report, 2007/08.

The key policies that induced these favorable fiscal developments varied across the two levels of government. At the central level, the enactment of the Fiscal Responsibility and Budget Management (FRBM) law in 2003/4 capped several years of technocratic and political efforts and gave a significant stimulus to the cause of fiscal consolidation.¹⁰ The FRBM Act targeted elimination of the centre's revenue

¹⁰ The bill was passed by Parliament in 2003 and enacted by the new (UPA) government in July 2004.

deficit by 2008/9 and a reduction of the fiscal deficit to 3 percent of GDP. It also specified minimum improvements towards these targets each year. The fiscal deficit target had been had been pretty much achieved by 2007/8, with relatively modest recourse to creative accounting, such as incurring of off-budget liabilities. (The current year, 2008/9, will be a wholly different matter, thanks to huge implicit and explicit subsidies for fuel, fertilizers and food as well as the effects of the Sixth Pay Commission and the loan waiver for farmers announced in the 2008/9 budget).

The second major policy initiative at the central level was a concerted and sustained programme to raise the tax- GDP ratio through better application of information technology and other means to strengthen tax administration.¹¹ Coupled with the remarkable acceleration in economic growth (especially of industry and services) after 2002/3, this helped to lift the centre's tax-GDP ratio (net of devolution to states) from 5.9 percent of GDP in 2001/2 to 9.2 percent in 2007/8 (Table 10). About three-quarters of this increase came from direct taxes, notably corporate and personal income taxes, whose share in total central government tax revenues rose to an unprecedented 50 percent in 2007/8 from 37 percent in 2001/2. Corporate taxes were exceptionally buoyant, with their share in central tax revenues increasing from below 20 percent to above 30 percent over this period (Government of India, 2008a)

Table 10: Centre's Fiscal Position- A Summary Review

(As percent of GDP at current market prices)

	2000/ 01	2001/ 02	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07	2007/08 (RE)
(1) Revenue Receipts	9.2	8.8	9.4	9.6	9.7	9.7	10.5	11.1
(2) Tax Revenue (net to centre)	6.5	5.9	6.5	6.8	7.1	7.5	8.5	9.2
(3) Non-tax Revenue	2.7	3.0	2.9	2.8	2.6	2.2	2.0	2.0
(4) Expenditure	15.6	15.9	16.8	17.1	15.8	14.2	14.1	15.1
(5) Revenue Expenditure	13.3	13.2	13.8	13.1	12.2	12.3	12.4	12.5
(6) Capital Expenditure	2.3	2.7	3.0	4.0	3.6	1.9	1.7	2.6
(7) Revenue Balance (1-5)	-4.1	-4.4	-4.4	-3.6	-2.5	-2.6	-1.9	-1.4
(8) Fiscal Balance	-5.7	-6.2	-5.9	-4.5	-4.0	-4.1	-3.4	-3.1

Sources: Economic Survey- various issues and Budget papers for 2008/09.

¹¹ See Acharya (2006, chapter 5) and Chakravarty (2004).

Table 11: State's Fiscal Position- A Summary Review*(As percent of GDP at current market prices)*

	2000/ 01	2001/ 02	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07	2007/08 (RE)
(1) Revenue Receipts	11.3	11.2	11.1	11.2	11.5	12.0	12.8	13.3
(2) Tax Revenue	8.0	7.9	7.9	8.0	8.3	8.6	9.0	9.3
(3) Non-tax Revenue	3.3	3.3	3.3	3.2	3.3	3.5	3.8	3.9
(4) Expenditure	16.0	16.5	16.7	18.7	17.6	15.7	15.9	16.7
(5) Revenue Expenditure	12.6	13.8	13.5	13.5	12.8	12.2	12.2	12.9
(6) Capital Expenditure	3.4	2.7	3.2	5.2	4.8	3.5	3.7	3.8
(7) Revenue Balance (1-5)	-0.9	-2.6	-2.3	-2.3	-1.2	-0.2	0.6	0.5
(8) Fiscal Balance	-3.3	-4.2	-4.1	-4.4	-3.4	-2.5	-1.9	-2.3

Sources: *Economic Survey- various issues and Annual Report 2007-08, RBI*

At the state level, the big improvements in fiscal consolidation occurred after 2003/4 (Table 11). Four major factors were at work. First, the remarkable growth in central tax revenues, noted above, also benefited the states, which received about 30 percent of these revenues under the tax devolution formulae mandated by the Finance Commissions.¹² Second, following the recommendations of the Twelfth Finance Commission (TFC), the non-tax revenue receipts of the states were buoyed by larger transfers of devolution grants from the central government. The TFC recommendations on debt relief and debt write-offs also catalyzed the adoption of fiscal responsibility laws by nearly all the states, since these benefits were made conditional on enactment of such laws. Fourth, after a long and tortuous process of technical work and political negotiation, nearly three quarters of the states reformed their sales taxes to a set of broadly uniform state value-added-taxes in April 2005. Most of the remaining states followed in subsequent years. This helped boost the states' own tax revenues significantly.

These major achievements in fiscal consolidation up through 2007/8 have come under severe pressure in 2008 from mounting subsidies for petroleum products, fertilizer and food, the large public pay increases following the Sixth Pay Commission and the proliferation of populist schemes such as the loan waiver for small farmers.

B. Foreign Capital Surge

Between 2002/3 and 2007/8 the level of net foreign capital inflows into India rose tenfold from \$ 10.8 billion to \$ 108 billion (Table 12). This unprecedented surge in external capital was both a cause and consequence of the country's remarkable boom in investment and growth during the years 2003/4-2007/8. As RBI governor Reddy (2005) had presciently warned, this extraordinary spurt in capital inflows posed major

¹² Effective 2004/5, the states' share in central tax revenues was raised from 29.5 percent to 30.5 percent.

challenges for management of the exchange rate, capital controls, monetary policy and inflation.

Table 12: Capital Inflows and Reserves

(\$ billion)

	2000/ 01	2001/02	2002/03	2003/04	2004/ 05	2005/ 06	2006/ 07	2007/ 08
1. Net Capital Inflows	8.8	8.6	10.8	16.7	28.0	25.5	45.8	108.0
of which (percent share) :								
Foreign Direct Investment	(37.0)	(55.4)	(29.7)	(14.3)	(13.3)	(11.9)	(18.5)	(14.4)
Foreign Portfolio Investment	(29.3)	(22.8)	(8.7)	(67.9)	(33.1)	(49.1)	(15.4)	(27.1)
External Commercial Borrowing	(48.7)	(-18.5)	(-15.6)	(-17.5)	(18.5)	(9.8)	(35.3)	(20.5)
Non-Resident Deposits	(26.2)	(32.2)	(27.5)	(21.8)	(-3.4)	(11.0)	(9.4)	(0.2)
Other	(-41.2)	(8.1)	(49.8)	(13.6)	(38.5)	(18.2)	(21.3)	(37.8)
2. Current Account Balance	-2.7	3.4	6.3	14.1	-2.5	-9.9	-9.8	-17.4
3. Increase in Foreign Exchange Reserves*	4.3	11.8	22.0	36.9	28.6	10.1	47.6	110.5

Sources: Reserve Bank of India: Handbook of Statistics on Indian Economy and Bulletins.

* Differs from (1) + (2) because of errors and omissions and valuation changes.

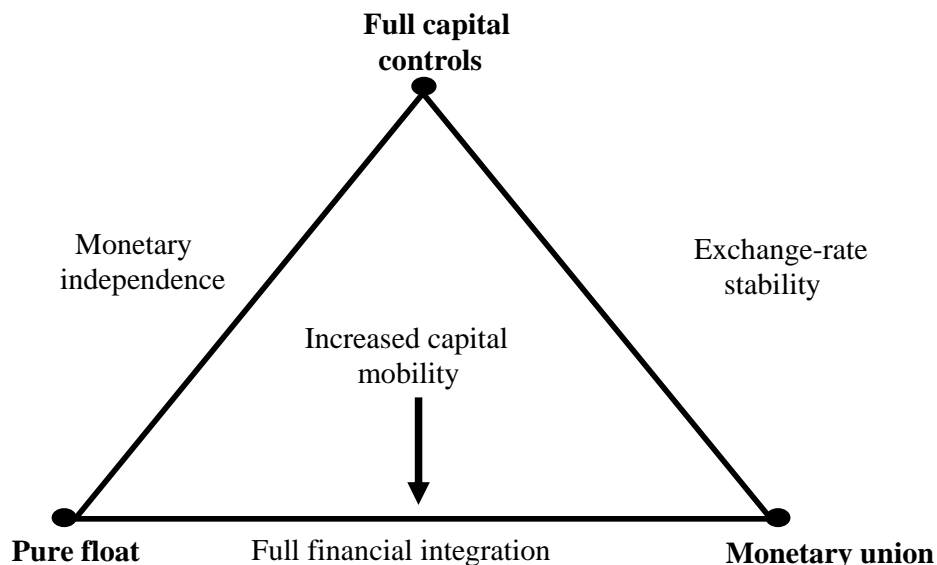
Confronted by rising capital inflows (at levels much higher than the current account deficit), the Reserve Bank (RBI) and government had the following basic options:

- allow the nominal (and real) exchange rate to appreciate;
- undertake unsterilized intervention, that is, maintain the nominal exchange rate through purchases of the surplus funds to augment reserves, with consequent increases in money supply and resultant inflationary pressures;
- conduct sterilized intervention, that is, forex purchases combined with compensatory sale of government securities by RBI to negate (or moderate) the increase in reserve money;
- loosen restrictions on outflows of capital;
- tighten restrictions on inflows of foreign capital;
- undertake some combination of the above policies.

The usual textbook prescription, typically advocated by IMF interlocutors, favours exchange rate appreciation as the primary response. This recommendation draws strength from open economy macroeconomic theory and the associated “Impossible Trinity”, which disallows simultaneous achievement of exchange rate stability, monetary independence and capital market integration. Any two of these goals may be attained (at the vertices of the triangle in Figure 3), but never all three. What this theoretical insight tends to downplay is the fact that, with partial capital controls, countries in India’s situation can enjoy substantial monetary independence together with a fair degree of autonomy over the exchange rate level in an “managed float” system. Indeed, this is a hallmark of “intermediate” exchange rate regimes like those

prevailing in India and China.¹³ India has followed a “managed float” since 1993, with fairly active intervention by the RBI to moderate market-driven volatility and maintain a “realistic” exchange rate. In practice, the latter has meant using the 1993/94 value of the 6 (earlier 5) currency, trade-weighted real effective exchange rate (REER) index as a benchmark or informal guidepost (*not* a formal target).

Figure 3: The Impossible Trinity



Source: Jeffrey Frankel, “No single currency regime is right for all countries at all times,” Princeton Essays in International Finance No.215, August 1999

In a similar, though much shorter-lived, external capital surge in 1993-95 India’s policy-makers had resorted successfully to a combination of sterilized forex intervention and liberalization of the external payments regime.¹⁴ This had checked the appreciation of the rupee and thereby nurtured a nascent export boom as well as preempting increased protectionist resistance to the ongoing programme of customs tariff reductions. This time too, the RBI and government opted for a similar strategy, although the task was substantially more challenging given the scale and longevity of this recent capital surge. Indeed, when the RBI ran out of government securities in 2004, these had to be freshly issued under the new “Market Stabilization Scheme” (MSS), jointly established by the government and RBI in March 2004, to enable the RBI to continue with sterilization operations.¹⁵ MSS operations were backed by the RBI’s short-term liquidity management through its Liquidity Adjustment Facility as well as occasional increases in the cash reserve ratio (CRR), especially in recent years.¹⁶ Outflows of capital were also significantly liberalized during this period,

¹³ I prefer to classify “managed floaters” as belonging to the category of “intermediate” exchange rate regimes (intermediate between the two poles of full flexibility and a “hard peg”), in contrast to Fischer (2001), who puts them in the “floater” category.

¹⁴ Acharya (2002b) provides a detailed account of this earlier episode.

¹⁵ RBI (2004) provides details of the MSS system.

¹⁶ For a detailed account of MSS operations and other measures deployed by the RBI to contain rupee appreciation see its Annual Reports over the period 2003-08.

encouraging a hefty increase in cross-border acquisitions by Indian companies. There was also a minor tightening of external commercial borrowing guidelines in 2007 and the prudential rules for participatory notes issued by foreign institutional investors.

The success of this approach in containing nominal and real appreciation of the rupee during most of this capital surge may be gauged by the trajectory of the real effective exchange rate up until 2006/7 (Figure 4A). The rewards came in the form of sustained high growth of both merchandise and services exports (noted in section I), which were integral elements of the overall economic growth story during this period. Of course, the sterilization operations did entail growing fiscal and quasi-fiscal costs. But, as Bhalla (2008) and others have pointed out, such costs were far outweighed by the higher growth benefits of a competitive exchange rate policy.

Figure 4A : Annual 6- country NEER and REER indices (1993/94=100; Trade-based weights)

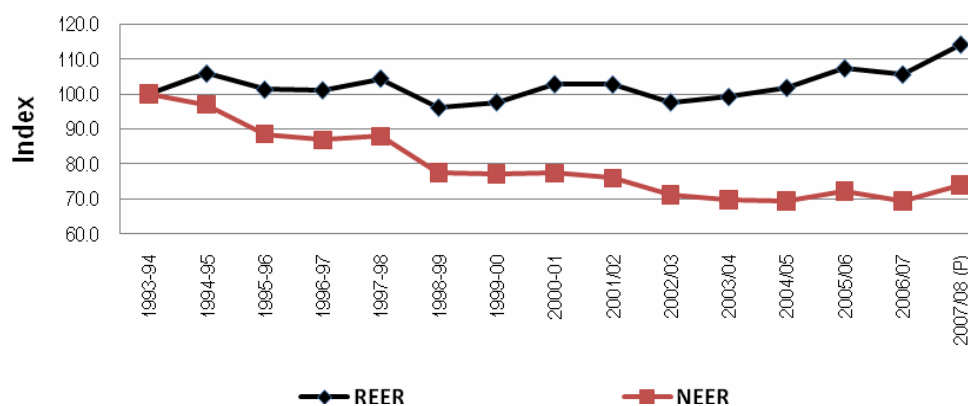
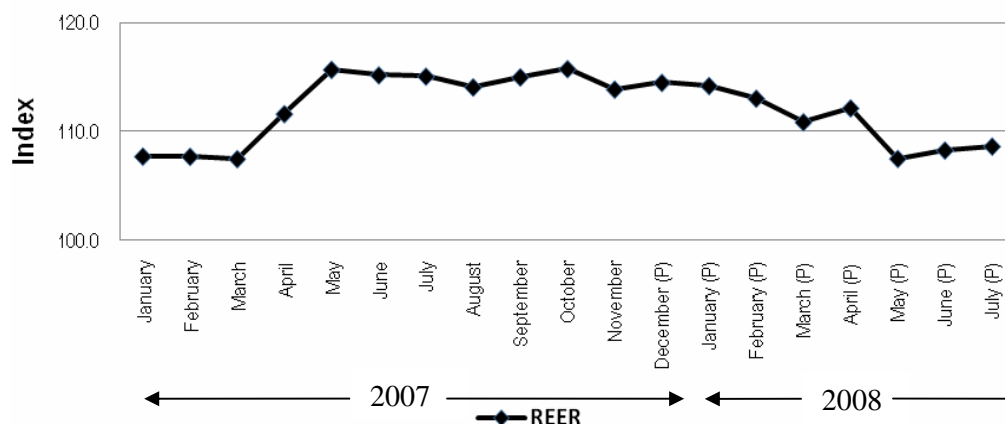


Figure 4B: Monthly 6- country index of REER (1993/94=100; Trade-based weights)



Sources: Reserve Bank of India: Handbook of Statistics on Indian Economy and Bulletins.

In spring 2007, as capital inflows rose steeply, the government and RBI seemed to falter in the pursuit of the chosen strategy, allowing a sharp appreciation of the rupee in March-May, 2007 (Figure 4B). However, as the spurt in capital inflows moderated in subsequent months, especially after the stock market declines of January 2008, this rupee appreciation was partially reversed and the earlier, long-established policy approach seemed to be resurrected. Incidentally, a significant part (over a quarter) of the massive spurt in capital inflows in 2006/7 and 2007/8 was in the form of external commercial borrowings, which were boosted by the premature loosening of borrowing guidelines by the government (Table 12).

On balance, judging by the outcomes in terms of the exchange rate, strong trade expansion, low inflation, investment buoyancy and record economic growth, the RBI-government strategy for managing the unprecedented capital surge appeared to have been remarkably successful. In hindsight, one significant weakness might have been the rapid increase in domestic liquidity over this period, since sterilization of capital inflows was only partial. This may have exacerbated the impact of the global commodity price shock which hit India in early 2008, resulting in a sharp acceleration in inflation from March onwards. However, it is doubtful whether politically feasible degrees of additional monetary tightening in 2004-07 would have made any significant difference to this inflationary upswing. As it is, the RBI sometimes found it an uphill task to secure government support for the steady tightening of monetary conditions (through increases in both policy rates and reserve requirements) that it carried out over 2004-07.

III. Key Issues for the Future

We noted at the end of section I that 2008 has confronted India with serious macroeconomic challenges, with investment and economic growth slowing, inflation soaring and fiscal and current account deficits widening sharply. Some of these important problems (such as inflation) may abate somewhat as the global commodity price shock subsides and international credit and capital markets stabilize. Here my focus is on three key issues, which I anticipate will continue to pose challenges in the medium term: the task of restoring fiscal balance; the difficult choices in regard to currency convertibility and exchange rate management; and the role of the central bank, the RBI.

A. Restoring Fiscal Balance

As we saw, by 2007/8, the combined fiscal deficit had fallen to 5.3 percent of GDP (the centre's to 3.1 percent) and the combined revenue deficit to 0.9 percent of GDP (the centre's to 1.4 percent), marking enormous progress in fiscal consolidation at both central and state government levels since the record deficits of 2001/2. However, this progress was a little exaggerated by the new trend of resorting to off-budget liabilities to fund growing subsidies for oil and fertilizers, where user prices were held down by government, despite steeply rising international prices. Thus, according to official accounts, in 2007/8, Rs. 20,333 crores of "oil bonds" were issued to the government-owned oil-marketing companies in lieu of subsidies to partially cover their losses stemming from controlled prices of petrol, diesel, LPG and kerosene (Reserve Bank, 2008). Similarly, Rs. 7,500 crores of "fertilizer bonds" were issued to the fertilizer companies to partially compensate their losses arising from controlled

issue prices of fertilizers. Together they amounted to Rs. 30,833 crores or 0.7 percent of GDP, not a trivial amount.

In effect, this practice understated the levels of the *true* revenue and fiscal deficits by this amount. As the RBI observes in its Annual Report for 2007/8, “ Although the issuance of such bonds does not directly increase the conventionally measured fiscal deficit, the proceeds from such bonds are used to effectively fund current subsidy expenditures. Their macroeconomic and financial market impacts, and crowding out of resource availability to the private sector are similar to expansion of the fiscal deficit” (Reserve Bank, 2008, p.25).

With international prices of oil, fertilizer and food continuing to rise after March 2008 and little adjustment in domestic user prices by government, the level of this “off-budget deficit” has risen sharply in 2008, especially when one adds unbudgeted expenditure demands from the farm loan waiver scheme (announced by government in February 2008) and the government pay increases following the Sixth Pay Commission (notified in August, 2008). The Prime Minister’s Economic Advisory Council reported in end July 2008 that “total off budget liabilities of the Centre could exceed 5 percent of GDP, over and above the budgeted central fiscal deficit of 2.5 percent” for 2008/9 (Government of India, 2008b).¹⁷ Adding the states’ fiscal deficit, after making some allowance for pay commission triggered salary increases, it seems reasonable to expect a combined (true) fiscal deficit of 10 percent of GDP or higher for 2008/9.

That would amount to a doubling, in a single year, of the combined fiscal deficit recorded in 2007/8 and could set a new record for the fiscal deficit in India. Since the overwhelming bulk of this increase is due to items on the revenue account, the combined (true) revenue deficit could soar fivefold to 5 or 6 percent of GDP, with an associated collapse in public savings. This is the enormity of the fiscal consolidation challenge faced by India’s policy makers in the latter half of 2008. It could be even worse if tax revenues drop below budget targets because of slowing economic growth, especially in industry.

It is ironic that after the enormous success in fiscal consolidation achieved in 2002-2008, the primary macroeconomic challenge confronting India for the medium-term is again one of restoring fiscal balance. In some ways the task ahead is harder because it may be unreasonable to expect the kind of revenue buoyancy experienced in recent years. Also, given the growing expenditure demands of recently launched populist schemes (such as the National Rural Employment Guarantee and the farm loan waiver) the prospects for expenditure compression may be limited. The two main feasible avenues for fiscal consolidation that will need to be pursued vigorously are upward adjustment (or decontrol) of controlled prices for fuel, food and fertilizers and large-scale sale of equity in government enterprises. However, both these options will face considerable political resistance in the likely scenarios of governance that may emerge in the 2009 general elections.

¹⁷ The report assumes an average price for oil of \$ 130 per barrel. If the average oil price is lower, the scale of additional off-budget liabilities incurred in 2008/9 will be correspondingly reduced.

In other words, the formidable task of restoring fiscal balance is likely to take several years, during which interest rates may remain elevated and investment and growth somewhat subdued compared to the buoyant experience of 2003-08.

B. Convertibility and Exchange Rate Management

The high tide of advocating rapid transition to full capital account convertibility (CAC) for emerging nations came in 1996-97, with the US Treasury and the IMF leading the charge and espousing enabling amendments of the IMF's Articles of Agreement. The Asian financial crisis of 1997/98 and the Russian debt default of 1998 provided hard knocks in the school of experience, which stalled the CAC evangelists. More recently, the astonishing rise of China and the recent spurt in India's economic growth (both without the benefits of full CAC) have contributed to muting the earlier enthusiasm.

The empirical literature has also supported agnosticism.¹⁸ More interestingly, Kose, Prasad and Terrones (2008) find that FDI and portfolio equity investment boost productivity growth, while external debt is negatively correlated, especially in poorer countries. This is reassuringly consistent with India's calibrated approach to CAC over the last fifteen years, steadily opening up to FDI flows and portfolio equity, while moving cautiously on debt flows, especially banking flows and short-term borrowing. Mainstream western economists now routinely stress the importance of prior conditions such as fiscal consolidation, low inflation, and a well regulated financial system, criteria which were stressed by the first Tarapore Report (Reserve Bank, 1997). Thus Eichengreen (2007) notes "it is more prudent that capital account liberalization wait on the prior implementation of other reforms to avoid precipitating a crisis."

It is all the more surprising to find trigger-happy recommendations in favour of a rapid move to CAC in the recent "expert committee" report on making Mumbai an International Financial Centre (Government of India, 2007). This report recommended achievement of full CAC within one year of its submission, that is, by spring 2008! Fortunately, the government and the RBI have paid little heed to this recommendation so far. In any case, the RBI has steadily liberalized capital account transactions, not only for foreign direct and portfolio investors but also for residents, especially companies. This has facilitated the massive increase in cross-border acquisitions by large and medium size Indian companies in recent years.

Given the upsurge in inflation since spring 2008 and the steep increase in the fiscal deficit, noted above, it would be unwise to accelerate the pace of capital account liberalization in the foreseeable future, especially given the damage potential of volatile capital flows, real sector inflexibilities and the differential treatment of emerging countries by international financial markets (Reddy, 2008a). Of course, a cautious, iterative approach need not accept Williamson's (2006) recommended thirty year horizon for CAC in India!

Another important reason for a calibrated approach to CAC is the need to maintain some discretionary autonomy over the exchange rate for some years to come. The

¹⁸ See, for example, Prasad, Rogoff, Wei and Kose (2003).

RBI's implementation of the "managed float" of the rupee since 1993 has served the country admirably, muting excess volatility while generally maintaining a competitive exchange rate. This policy has been the key determinant of rapid growth in exports of goods and services and has greatly facilitated India's growing integration with the world economy (Bhalla, 2007, 2008). Any sudden (as in spring 2007) or sustained appreciation in the real effective exchange rate would be particularly damaging for the development of labour-intensive production (for both exports and domestic markets), which remains seriously handicapped by other major constraints, including rigid, anti-employment labour laws, poor infrastructure and weak human resource development policies. In these respects the Indian situation is much worse than in China, which maintained a significantly under-valued exchange rate for many years to consciously (and successfully) promote explosive growth of labour-intensive exports, despite the build-up of huge current account surpluses (Eichengreen, 2007 and Bhalla, 2007). Of course, a gradual upward drift in the real effective exchange may be warranted if India's productivity increases outstrip those of her major partners and competitors in the years ahead.

Such an eclectic approach to the choice of exchange rate regime and its management is also supported by recent reviews of experience and lessons of exchange rate regimes in emerging countries (Frankel, 2003).

C. Role of the Reserve Bank

In recent years there has been vigorous debate on the appropriate role of the RBI in India's future. At present, the RBI explicitly pursues multiple objectives of low inflation, sustainable economic growth and "orderly conditions in the foreign exchange market" (Reddy, 2000). It is also responsible for the regulation of banks and other deposit-taking institutions and has shouldered the objective of overall financial stability. Furthermore, the RBI acts as banker to the government and manages the government's debt operations. This is quite a portfolio of objectives and responsibilities.¹⁹ Some recent commentary has recommended that the RBI should focus on the single objective of low inflation and divest itself from its other objectives and responsibilities. For example, this is the first recommendation of the recent draft report of the Raghuram Rajan chaired "Committee on Financial Sector Reforms" or CFSR (Government of India, 2008c).

Such a recommendation may reflect a 15-year trend in a number of developed countries (including Australia, New Zealand and UK) to restructure their central banks to focus on the single objective of price stability through appropriate monetary policy. It tends to accompany three other features: statutory independence of the central bank, a fully flexible exchange rate policy (a "clean" float) and a separate and single financial services regulator for banks and other financial intermediaries. For example, the UK adopted this model in 1997.²⁰

¹⁹ Reddy (2008b) provides an illuminating and authoritative recent account of the RBI's objectives, responsibilities and dilemmas.

²⁰ Interestingly, the US Federal Reserve is charged with multiple objectives and clearly accorded enormous weight to the objectives of financial stability and sustaining economic activity in its actions throughout the recent, "sub-prime" triggered credit crisis.

While the CFSR recommendation may have some relevance for the long-run, it seems wholly inappropriate for present conditions in India for several reasons. First, for the RBI to divest itself of its other objectives and responsibilities raises the immediate question of who is to take them on? The CSFR report is not particularly educative on this. Second, in the present and foreseeable political economy of India, it is difficult to envisage the RBI being able to conduct its monetary policy without explicit consideration of the short term consequences for the level and growth of economic activity. Third, as I have argued above, if the present system of a “managed float” with partial capital controls is appropriate for India, it is obvious that only the RBI can discharge this responsibility. Fourth, financial stability is clearly a key macroeconomic objective, which cannot be wished away. Here too there is no other viable alternative to the RBI for pursuing this goal in the present stage of institutional development. That also means that the regulation and supervision of banks and near-banks has to remain with RBI.²¹

An area where change may be warranted in the near term is the divestment of the responsibility for managing the government’s debt to some independent body. However, the issue is far from clear cut, since the new body could be subject to even more pressure from the issuer of debt, the government. The other major area requiring reform is the quality and content of the RBI’s regulation and supervision of banks but a discussion of this subject is beyond the scope of this paper.

D. Coping with International Uncertainty

This is being written in the autumn of 2008 when the sub-prime-based international credit crisis has led to huge upheavals in the world of global finance, including the demise of stand-alone Wall Street investment banks, massive government and central bank support to banks, mortgage lenders and other financial intermediaries in the United States and Europe, bankruptcy of some large financial institutions, government guarantees of bank deposits in many countries, unprecedented turmoil in inter-bank lending and a massive \$ 700 billion bail-out plan in the US. The impact of the financial crisis on the real economy in these countries has begun, including falling output and investment and rising unemployment. The depth and duration of the recession is still unclear but the available signs don’t bode well.

In this background, there are likely to be major challenges for macroeconomic management in India in both the short and medium term. In the short run, as global financial investors liquidate their assets under stress, there are (and will be) large outflows of portfolio capital from Indian markets, a slowdown in direct foreign investment inflows, and increasing scarcity of commercial loans from abroad. Already, the equity markets are down over 40 percent from their January 2008 peak, the nominal exchange rate has depreciated around 15 percent against the US dollar and there has been a sharp tightening of short-term liquidity. The RBI has responded with a “managed” (through reserves sales) downward flexible exchange rate policy combined with injections of liquidity through various channels. As long as present pressures last, these are the appropriate priorities for short-term management.

²¹ It is noteworthy that the UK system failed to deal effectively and swiftly with the stability issues raised by the Northern Rock episode in September, 2007, partly because of the 1997 separation of banking supervision functions from the Bank of England.

In the medium term, as the world economy inevitably slows and transmits a deflationary impulse to India over the next year or two (or longer), monetary policy (which had been tightened in the last four years) will need to be steadily loosened to cushion the negative impact on domestic investment and consumption. Exchange rate policy will need to be flexible and agile with, probably, a downward bias. Even then, the reduction in trade and external capital inflows is likely to reduce India's growth to around 7 percent or so for a couple of years from the 9 percent plus average of the past three years. Whether this "growth recession" is greater (or less) or longer (or shorter) will depend mainly on the severity of the downturn in the major industrial economies and the quality of India's policy response to the weakened international economic environment. Clearly, swifter fiscal consolidation and effective forward movement on long-pending reforms in infrastructure, agriculture, labour laws, banking, energy, education and retail trade could compensate for the unavoidable downdraft from the international economy.

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