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**Performance of Indian Economy and Emerging
Challenges**

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I. Introduction:

The recent growth performance of Indian economy has attracted attention of the world community as never before. As stated by the Prime Minister of India in his address to the National Development Council, “Rare are the moments of history when a nation suddenly captures the imagination of the world”. Surely, India is the latest poster baby and the attraction comes from its vast consumer market from the burgeoning middle class as it opens up enormous opportunities for trade and investment.

Indeed acceleration in economic growth in recent years is the consequence of economic liberalization initiated in 1991. However, after the first wave, the reforms have moved only at a snail’s pace the there is much to be done to free the economy from the vestiges of autarchic regime. As the economy integrates itself with international markets, the challenges are manifold. Domestic commodity markets get integrated with international markets. Mobility of capital and labour create severe complexities and as production and exchange systems change, both policies and institutions will have to brace themselves upto dealing with the new systems. International financial flows are even more complex and calibration of reforms in this area has to be done carefully.

Equally important is the challenge of accelerating growth while managing the environmental sustainability. Climate change poses serious problems particularly to the poor and it consumes significant resources in minimising the damage and rehabilitation. Furthermore, accelerating economic growth would require increased use of fossil fuels at a time the focus should be to reduce the CO₂ emissions. Thus there is a clear trade off between addressing the goals of climate change and accelerating economic growth.

While the policy challenges in the changing environment have become formidable, the political class is yet to gain maturity to deal with them. The emergence of coalition of parties in power at the Centre, regional parties becoming pivotal members of the ruling coalition, emergence of opposition parties in many of the states and declining time horizon of political parties and politicians, are some of the important factors that have adversely impacted on the economic reform scenario. Not surprisingly, the much

talked about second phase of reforms has remained largely at the discussion level. It is important to activate reforms on many fronts both to close the gap between the actual and potential growth and to make it inclusive.

Sustainable development of Indian economy in globalizing environment poses a variety of challenges for Indian policy makers. Facing international competition requires creation of world class infrastructure, ensuring adequate flexibility to the manufactures in their production decisions, a stable macroeconomy and development of capacity in institutions to cope with complexities of exposure to international economy. Indian economy still has vestiges of planned economy and freeing it from the shackles of various controls and regulations on the one hand and erecting a structure of modern system of regulation on the other are important. Open economy has to contend with the complexities of mobility of capital. Calibrating a stable and a sustainable fiscal and monetary in an environment of surging capital flows, developing capacity absorb surging capital flows, and minimising the contagion from the vagaries of international financial markets are major policy challenges which the policy makes have to cope with. The most important challenge to be faced, however, is the coping with the challenge of adaptation to and mitigation of climate change. As stated in the Human Development report, “Climate Change is the defining human development issue of our generation. ...Climate Change threatens to erode human freedoms and limit choice” (UNDP, 2008; p. 1). In Indian context, besides coping with the adversities created by the climate change, the critical issue to be addressed is the trade off between the goal of mitigation while accelerating economic growth in the country. This note analyses the recent growth performance of Indian economy, the need to make it inclusive and the emerging challenges in maintaining the growth momentum and making it inclusive.

II. The Growth Story:

The growth performance of the Indian economy in recent years has been impressive. During the period from 2000-01 to 2007-08, the GDP recorded an average annual growth of 7.8 per cent and for the five years beginning 2003-04, the average growth rate was 8.8 per cent. In each of the last three years, the economy achieved a

growth rate of over 9 per cent and this was the highest growth rate achieved during any three-year period in the history of independent India. While there can be cyclical variations as is seen in 2008-09, the country has definitely reached a higher growth trajectory and a growth target of 9 percent for 11th Plan no longer looks unrealistic.

Indeed, after four years of spectacular growth, the Indian economy is slowing down in the current fiscal (2008-09). A number of factors inimical to growth have intensified and these include global economic slowdown, impact of the financial crisis in the United States and tightening of equity and credit markets, increasing commodity prices particularly the price of crude oil, virtual moratorium on economic reforms due to compulsions of coalition politics and binding infrastructure bottlenecks. Not surprisingly the economy is showing clear signs of deceleration. In spite of these, the Reserve Bank of India predicts the economy to grow at 8 percent and the projection by the Economic Advisory Council to the Prime Minister is 7.7 percent (India, 2008). Other projections vary from 7.5 percent to 8 percent. Considering the adverse conditions noted above, the deceleration can be termed as mild and the growth rate of 7.5 to 8 percent in the prevailing environment is quite impressive.

An important feature of the last 60 years of Indian economy is the steady acceleration in its growth performance over the years. The first three-and-a-half decades of planned development strategy yielded an average annual growth of 3.5 per cent. Although this was significantly higher than the virtual stagnancy that prevailed during the 50 years prior to independence, it was marginally higher than the population growth rate and was not sufficient to make any appreciable impact on the living conditions of the people, particularly the poor. The next twenty years beginning 1980-81 have seen the economy accelerating to 5.8 percent per year. Indeed, economic liberalisation undertaken in the latter half of the 1980s and the systematic reforms launched in 1991 have led to steady acceleration in economic growth from one period to another and since 2000-01 the economy has been growing at 7.8 per cent per year (Panagariya, 2008).

Along with the acceleration in economic growth, Indian economy has gained substantial resilience over the years. There has been a marked decline in the year to year fluctuations in the growth rate. After three continuous years with more than 9 percent

growth, even as the economy shows clear signs of slow down, the projected growth of 7.5 to 8 percent and this, by any reckoning, is remarkable. The fact that economy continues to grow at the rate in spite of several adversities and downturn in global economy and pessimistic market environment shows the maturity the economy has gained over the years. In the past, fluctuations were due to vagaries of monsoon and large weight of primary sector in the GDP.

An important reason for both growth acceleration and greater resilience is that economic reforms have unleashed productive energies in manufacturing and even more, service sectors of the economy. Not surprisingly, acceleration in the growth in these sectors on the one hand and near stagnancy in the agricultural sector after the first wave of green revolution on the other, have contributed to a steady decline in the contribution from agricultural sector over the years. In 2006, the primary sector's contribution to GDP was just about 17 per cent, secondary sector contributed 28 per cent and the contribution of the service sector is 55 per cent. Therefore, the low growth rate of agriculture has not pulled down the aggregate growth rate markedly. Since 2001-02, over 70 per cent of the growth has been contributed by services, manufacturing contributed 25 percent and the contribution of the primary sector was just about 5 percent. Given that the volatility in agricultural sector has been high, the steady decline in the contribution of the sector has resulted in the lowering of the fluctuations in the growth performance.

Significant growth acceleration in recent years is underlined by distinct increases in saving and investment rates. The ratio of savings to GDP increased from 26.4 percent in 2002-03 to 36.2 per cent in 2007-08, and investment rate during the period increased from 25.2 per cent to 37.4 per cent. The sharp increase in the savings rate was mainly due to improvement in corporate savings and partly on account of turn-around in public sector savings based on improved public finances. The private corporate sector savings as a ratio of GDP increased from about 5 per cent in 2002-03 to 7.8 per cent in 2006-07 and public sector saving which was negative in 2002-03 increased steadily to 2.3 per cent in 2006-07. The private investment has shown a sharp increase from about 17 per cent of GDP in 2001-02 to 28.1 per cent in 2006-07.

Acceleration in economic growth in the country has come about not merely on account of sharp increases in the investment ratio but also due to growth in total factor productivity. Studies show that both industry and service sectors have recorded gains in productivity and these have been more pronounced in the case of the latter. Significant lowering of the import duties has helped to make productivity gains in industry. The import weighted average duty declined from close to 94 per cent in 1991-92 to 6.4 per cent in 2007-08 in the case of capital goods, and in the case of consumer goods declined from 114 per cent to 23.3 per cent, and in the case of intermediate goods from 65.6 per cent to 9.3 per cent. While there was much apprehension in the manufacturing sector when import duties were reduced, today the industry is brimming with confidence and the much feared external imbalance did not take place as growth in both goods and services recorded impressive gains and the current account trade imbalance was substantially offset by exports from the services sector. As competitiveness in the economy improved over time, there has been a steady flow of foreign investment and from April to December 2007, the volume of foreign investment was about US\$51 billion which is almost double the investment received during the entire fiscal 2006-07. It goes to the Indian corporate sector that they have not only performed well domestically but have gone about acquiring companies abroad. During 2006-07, almost 90 software foreign companies were acquired by domestic companies and the acquisitions in the health care and pharmaceutical sectors were 62 companies, in automobiles sector 27 companies and in chemicals and fertilizers 19 companies.

After three successive years of above 9 per cent growth, the economy has been showing signs of a slowdown. A number of factors such as the global slowdown, rising commodity prices including the price of crude oil, and high interest rates have adversely impacted on the growth scenario in 2008. Despite attempts to de-couple the economy from the turbulence in international financial markets and insulate it from global price trends, slowdown is imminent. The sub-prime lending crisis and more recently, severe volatility due to vulnerability of major banks and financial institutions in the United States is likely to have adverse impact on the financial markets. In addition, the poor state of infrastructure, particularly the shortfall in the supply of power to meet the required demand is likely to pose a binding constraint. Thus, growth rates of both

industry and service sectors of the economy are expected to decelerate. The projections by the Economic Advisory Council to the Prime Minister is that industrial sector is expected to decelerate by one percentage point and grow at 7.5 per cent during 2008-09 and the service sector is expected to decelerate from 10.2 per cent in 2007-08 to 9.6 per cent in 2008-09. Altogether the GDP in 2008-09 is projected to grow at 7.7 percent as compared to 9 percent in the previous year. Despite the slowdown, the projected growth rate of 7.7 percent in the current fiscal is creditable and this shows the resilience that the economy has gained over the years.

On the balance of payments front, the estimate shows that the economy has shown a current account imbalance of 1.5 per cent of GDP in 2007-08. However this is expected to increase sharply to 3.2 per cent in 2008-09. The merchandise imports are expected to exceed the exports by almost 10.4 percent of GDP but the net invisibles are likely to reduce the imbalance substantially to record current account imbalance by only 3.2 per cent of GDP. However, as capital account is estimated to record a surplus of 9.2 per cent, mainly due to the increase in foreign direct investment, portfolios and loan inflows, management of the external sector will not pose any serious problems.

III. Making the Growth Inclusive

A major concern of the policy makers is that even as there has been a significant acceleration in growth, the benefits of economic growth have eluded large disadvantaged sections of population. Much of the growth has occurred in the industry and service sectors and agricultural sector has been stagnant. Agricultural sector with 52 per cent of employment share generates just about 17 per cent of GDP. The lopsided pattern of growth has impacted adversely in regions with large agricultural base. Thus, some of the poorer states, where the vast majority of the poor people reside have shown very low growth rates resulting in increasing regional disparities. The states with developed markets and good physical and social infrastructure have grown at a much faster rate than the others and this is surely a matter for concern.

Indeed, the fast pace of economic growth has helped to improve the living conditions of many poor, but poverty remains a major problem. Although the head-count

measure of poverty computed by the Planning Commission shows an impressive decline from 26 per cent in 1999-2000 to 21.8 per cent in 2004-05, the rate of decline in poverty is fast enough and over 220 million are below the poverty line. In fact, according to a recent World Bank study measuring poverty by assuming the poverty line at USD. 1.25 a day in 2005 PPP estimates that the number of poor people in India increased from 421 million in 1981 to 456 million in 2005.

Equally worrisome matter is the employment trend. During the period from 1993-94 to 1999-2000, while the economy registered a growth of over 6.5 per cent, the employment growth was 0.98 per cent and this was almost entirely in the unorganised sector. Since 1999-2000, however, at 2.9 per cent per year, the growth of employment has been higher than the entry into labour force and was much higher than the previous period. The problem, however, is that the growth of employment has come about only in the unorganised sector and employment in the organised sector has shown a decline. While annual employment in the unorganised sector increased by 3.2 per cent, the organised sector employment declined by over 1.1 per cent. These results clearly point out the adverse impact of labour laws. Any increase in organised sector employment would surely require reform in labour laws.

IV. Emerging Challenges

(i) Challenges of transition to market.

The optimistic scenario painted above should not obscure the major challenges to be faced for sustaining high economic growth in the country and making the growth inclusive. The much vaunted second generation reforms are yet to take off the ground and the policy framework does not still provide a clear structure of incentives to economic agents. Sustained economic growth at 9 percent and more is possible only when stable and sustainable macroeconomic environment is maintained and the stalled reform agenda is revived. Reforms have to restructure the policies and strengthen institutions to create enabling environment for the markets to function. The immediate measures needed include maintaining fiscal discipline to contain fiscal deficit, reforming the tax systems to improve revenue productivity and minimise distortions and reforming fiscal management systems to improve productivity of public spending. In addition, it is necessary to replace

government's pricing and output decisions with market decisions, continue with internal and external liberalisation, deepen the markets and strengthen the regulatory system to increase competition in the economy. Inclusive growth also calls for policy focus to improving agricultural productivity and creation of sustainable off farm employment opportunities for the rural population and emphasis on skill development of the unskilled in both urban and rural areas to enhance their productivity and incomes. Decontrolling the industries controlled at present, allowing foreign direct investment into the retail and insurance sectors, enactment of bankruptcy laws, allowing entry of private sector into some of the sectors that are hitherto considered a public sector preserve such as coal mining and doing away with labour laws are some of the other policy reforms that are required to generate the incentives. Many of the State government laws relating are obsolete and need to be reviewed.

(ii) Surging capital flows and macroeconomic management.

Ensuring a stable macroeconomic management in a globalising environment is an extremely complex task. Surging capital inflows in emerging market economies like India can result in currency appreciation and create "Dutch disease" type of situation. The Reserve Bank of India has been sterilising the capital inflows to keep the exchange rate at competitive level. Although in recent months, the capital flow situation has actually reversed, it is a temporary phenomenon. Sterilising the capital flows by the Reserve Bank of India augments the money supply and reduces the flexibility in calibrating monetary policy. At the same time, the enactment of the Fiscal Responsibility and Budget Management Act (FRBMA) has not helped to bring down the overall fiscal liabilities of the government. Though the combined budgeted fiscal deficits of Central and State governments are 5.5 per cent of GDP, off-budget liabilities arising from the bonds to be issued for fertilizer, food and oil subsidy, the liabilities arising from the pay revision and loan waivers constitute an equal additional amount. The large deficits tend to put pressure on the credit market and tend to financially crowd out the private investment, with adverse impact on economic growth. As the country approaches another general election, the competitive populism is likely to rule and expenditures are likely to increase which will put even greater pressure on the fiscal deficit.

(iii) maintaining fiscal discipline

Persistence of large fiscal liabilities has delayed the much needed capital account convertibility. Large fiscal liabilities lead to financial repression and weakens the banking and financial system. Public ownership makes the system even more vulnerable to political influence in decisions. Besides hindering the development of credit market, the lack of contestable competition in the financial system has not helped to develop robust and mature credit market. As overwhelming proportion of the credit portfolio of the banking system is pre-empted through Statutory Liquidity Ratio (SLR), Cash Reserve Ratio (CRR) and priority sector lending, the commercial banks cannot ensure low cost funds for the private investments. The bond market is still in its infancy and much of the government bonds are bought by the Reserve Bank of India and off loaded to the commercial banks, only secondary trading takes place and that is extremely thin. There is need for considerable reforms to free the financial sector from rationing and repression.

(iv) Overcoming the infrastructure deficit.

Equally worrisome concern that has impeded investment flow and constrained economic growth performance in the country is the infrastructure deficit. For improving industrial performance, it is imperative that infrastructure constraints are removed particularly in energy, roads, ports, airports and urban infrastructure. While in some areas such as roads and airports it has been possible to make the private sector to participate in infrastructure investment, in many others the progress has been slow. The fiscal pressure has limited the government's ability to provide viability gap funding. Further, in many other areas, government will have to continue to make investment. Total capital expenditure at the Central and state levels in 2008-09, is estimated at 4.8 per cent of GDP and this is clearly not adequate.

(v) Creating responsive and accountable institutional environment.

There is considerable reform that is needed to create an appropriate institutional environment as well. Vestiges of autarchic economic regime have continued and there is still a lot of faith in the protectionism and the role of the public sector, which can be seen in many spheres. The prevailing institutions do not provide the structure of incentives

necessary for faster growth and much more remains to be done in strengthening and deepening the market. There are difficulties of formulating appropriate policies with speed in the prevailing political environment. The emergence of coalition government the centre, regional parties as pivotal members of the ruling coalition, and declining time horizon of political parties with significant influence by special interest groups has led to adoption of policies with regional rather than national perspective and policies that bring in short term gains rather than lasting structural improvement.

(v) making the growth inclusive.

To make the growth inclusive, there has to be a clear policy towards accelerating agricultural growth. The problem is particularly severe in the three poorest states of Bihar, Uttar Pradesh and Orissa. In these states, management of water resources has become a major problem and, in fact, significant investments are required to prevent flooding and to improve agricultural practices. While the country clearly can avail dividends from the demographic dividend, for, by 2035, almost 69 per cent of the population will be in the working age between 16 and 55, benefits from this can be reaped only when the skill levels of the population is significantly improved and they are employable. Analysis shows that the literacy rate of the population continues to be low at 64.8 per cent according to 2001 census. Furthermore, less than 9 per cent of those passing grade 12 actually go in for higher education. This implies that a large proportion of the population is totally outside the school curriculum and even among those who go to the school, overwhelming proportion do not secure the skill levels necessary for secure employment, higher productivity and wages. Massive outlays in vocational education and skill development will have to be undertaken both by the public and private sector to make them employable. Equally important is the need to facilitate formalisation of the informal sector including the removal of labour laws to enable the corporate sector to employ more labour.

(vi) Climate Change and the poor

The most important challenge faced by the policy makers today is dealing with climate change. Reckless mismanagement of environment has created unsustainable ecological debt, which, the future generation will have to suffer. Even in the present

generation the poor will suffer the most due to adverse impact on agricultural productivity, leading submergence of low level coastal areas and increased frequency of extreme events (Parikh and Parikh, 2002). Overwhelming proportion of greenhouse gas emissions are from developed countries and the share of the United States alone is 23 percent. However, it is the poor in the developing countries who will have to bear the brunt of the adverse impact of climate change.

India is highly vulnerable to climate change as it reduces agricultural productivity and endangers food security, displaces a large number of people when the sea level rises and exposes the poor to the incidence of extreme events. It is estimated that one metre rise in the sea level will displace 7 million persons in India (ADB, 1995). It is therefore, imperative that the country adopts measures aimed at both adaptation to and mitigation of climate change. The most important measure of adaptation is development itself and acceleration of inclusive growth is the key to combat adversities.

It is adopting appropriate mitigation strategy that India faces a dilemma. Although India is seen to be the fifth largest emitter of greenhouse gases (Sathye, Shukla and Ravindranath, 2006), India's share in CO₂ emissions is a mere 4 percent. Given this low level of emissions, measures at mitigation by India is unlikely to have any impact on climate change (India, 2008a). At the same time, accelerating growth in the economy would require substantial augmentation of the infrastructure, particularly electricity. Over 79 percent of the prevailing electricity generating capacity is thermal which is predominantly coal based. Indeed lifting of the embargo by the Nuclear Suppliers' group may help in creating additional capacity in the cleaner nuclear power generation in the long run. Nevertheless, given the large domestic reserves of coal, a significant expansion in electricity generation will come from coal based thermal plants. Thus, accelerating economic growth will entail increase in emissions and the country will have to take several measures such as increasing the generation of renewable energy and afforestation. Even so challenge of accelerating growth in an environmental sustainable manner is a real challenge.

IV. Concluding Remarks

The Indian economy has shown a remarkable growth performance in recent years. There has been a steady acceleration in the growth of GDP over the years and it averaged 7.8 percent during the current decade each of the last three years, the growth has exceeded 9 percent. Despite significant decline in the poverty following acceleration in growth, the number poor continue to be large. Although the global economic slowdown, increasing international commodity prices, large fiscal liabilities, hardening credit market and inflationary environment has posed constraints, the economic growth in 2008-09 is expected to be around 7.5 to 8 percent which is quite creditable.

It is important to note that the high growth is the outcome of the sustained though slow reforms since 1991. However, sustaining high growth in the medium and long term will require the government to fast track the reforms in many areas to free the economy from the clutches of political vagaries and bureaucratic control. The paper identifies reforms in policies as well as institutions to be undertaken to accelerate growth and make the growth inclusive. Reforms in policies include fiscal, monetary and financial sector reforms to ensure macroeconomic stability and free the resources for productive use, reforms to enhance agricultural growth and create off farm employment opportunities in rural areas and labour reforms to enlarge employment opportunities in the organised sector. Institutional reforms are necessary to strengthen the market institutions and to ensure appropriate incentives and accountability. The most important challenge faced in the economy is to accelerate inclusive development of the country in an environmentally sustainable manner.

The challenges of accelerating the pace of reforms in India are formidable. At the same time, fast tracking these reforms is extremely important for accelerating and sustaining high growth and making the growth inclusive. Although as Lord Keynes said, "...soon or late, it is ideas, not vested interests, which are dangerous for good or evil", the immediate task of the government is to overcome the hurdles from the vested interests in implementing reforms. Indeed, over four decades of autarchic economic regime has created several vested interests. Although two decades of partial economic freedom has

brought a lot of consensus on the need for reforms, the pace has been slow. According to Jagdish Bhagwati, “Indian economic reforms may be like a bullock cart stuck in the mud in the monsoon: it will not slide back nor will it move forward” (Snowdown, 2004; pp. 235). Indeed, the hope lies in proving this wrong and hopefully, after the elections, the pace of reforms will accelerate.

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