Current Challenges for the Economy and Priorities of the New Government

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Foreword

After sustaining an average growth of over 8 per cent during 2003-2012, India witnessed a sharp deceleration in growth of less than 5 per cent in next two years. While initially this slowdown was attributed to a fragile global recovery, it was latter realised that domestic factors have perhaps contributed more to this sluggishness.

As this paper has observed that the macro fundamentals were indeed pointing to this slowdown, notwithstanding the smart recovery in two years of 2009-2011, immediately after the global economic meltdown. But a sharper moderation in growth than even the most pessimists had earlier visualised was due to depressed sentiments, depressed investment and capacity constraints and the perceived policy logjam. These were also the factors which contributed to inflation which remained stubborn despite many upward revisions in policy rates by the Reserve Bank of India.

Besides setting the challenges that our economy faces in a historical perspective, the paper suggests policy options. Centad hopes that this working paper will generate informed discussion and provide important inputs for policy interventions.

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Current Challenges for the Economy and Priorities of the New Government

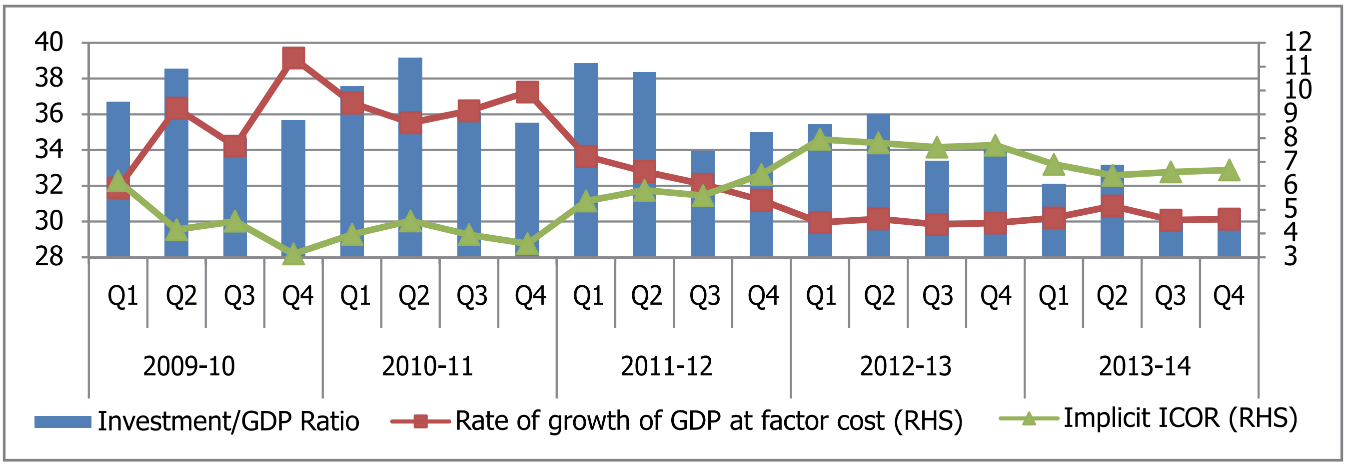
With a new Government having been established it is important look at the way ahead based on the constraints which the economy had faced in the recent years. We consider four important areas which may need an immediate attention of the Government. These include: providing new stimulus to growth by reducing infrastructure and regulatory constraints which had affected investment and efficiency of capital; creating an enabling environment which would encourage manufacturing and job creation outside the agriculture; reduce the inflationary pressures, particularly the persistently high inflation for food products; and continue the fiscal consolidation without endangering public investment.

Accelerating economic growth and investment- Issues and Options

1. After a smart recovery to a growth of 8.6 per cent in 2009-10 and 8.9 per cent to 2010-11 in the aftermath of global meltdown of 2007-08, economic growth significantly moderated in next three years to 6.7 per cent in 2011-12, 4.5 per cent in 2012-13 and 4.7 per cent (Revised Estimates) in 2013-14. While the slow-down in the growth was to an extent anticipated, based on the global as well as domestic macro-economic parameters, a sub 5 per cent growth in 2012-13 and 2013-14 was even lower than the initial estimates/ projection. The slow-down which was initially viewed as arising due to fragile global economic recovery and stalled infrastructure projects and slowing corporate investment became more generalised with delayed project approvals/implementation creating supply side bottlenecks and inflationary pressures. Depressed sentiments together with regulatory delays (often perceived as policy paralysis) also contributed to sluggish growth.

2. India's growth rate declined almost continuously over several quarters from Q1 2010-11 till Q4 of 2013-14 (Fig 1). Although it seems to have bottomed out, overall growth of the manufacturing and exports remain flat. Current data on lead indicators such as purchase of vehicles, consumer durables and housing also suggest that the recovery is still fragile.

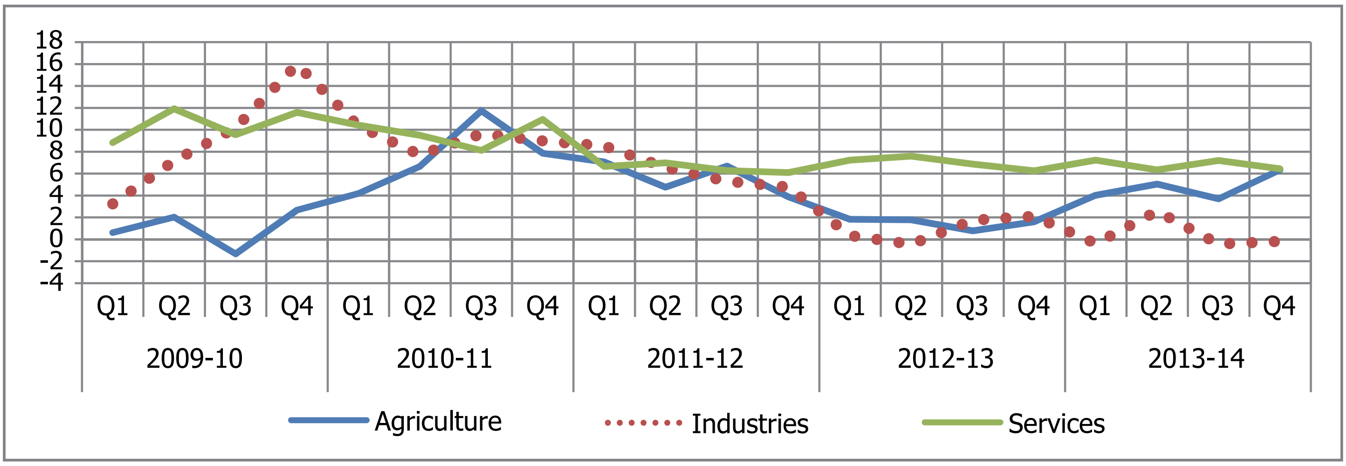
Fig 1: Investment, GDP growth and Productivity



Source: Calculation based on Central statistical Office Press Notes

3. Quarterly GDP growth at broad sectoral level indicates that the current moderation is largely due to a sharp moderation in the growth of industries (comprising the mining, manufacturing, electricity and construction sectors). Though the agriculture growth has fluctuated depending on the level of rains, a decline in the growth of industries has mainly contributed to sluggish GDP growth (Fig 2).

Fig 2: Sectoral GDP Growth (per cent)



Source: Calculation based on Central statistical Office Press Notes

4. Before we look at the recent factors constraining growth, it may not be out of place to look at the broad structural issues (Table 1). Indian economy witnessed a moderate growth of 3.5 per cent, often referred as Hindu rate of growth, in first thirty years of its independence. Growth started showing some signs of acceleration during 1980s with average growth improving to 5.2 per cent during 1980-81 to 1991-92. In the decade immediately following the economic reforms, growth remained range bound and generally stable. GDP Growth significantly accelerated during 2003-04 to 2007-08 period reaching 8.7 per cent. Global economic crisis resulted in slowing of the domestic economy in 2008-09. Though a structured stimulus package in terms of tax concessions and monetary easing resulted in a swift recovery of GDP growth to earlier levels, this could not be sustained. High inflation, a tight monetary policy together with delays in project clearances and commissioning and a fragile economic recovery in advanced and emerging economies lead to a sharp moderation in growth to sub 5 per cent in 2012-14.

Table 1: Macro Economic Parameters of Indian Economy

Growth Phases	I	II	III	IV	V
In per cent	**1950-51 to 1979-80**	**1980-81 to 1991-92**	**1992-93 to 2002-03**	**2003-04 to 2007-08**	**2008-09 to 2012-13**
GDP Growth (at Factor Cost and at 2004-05 prices)	3.49	5.21	5.92	8.68	7.08
Capital Formation /GDP	14.48	20.96	24.42	33.61	35.53
Fixed Capital Formation/GDP	13.54	20.86	23.30	29.56	31.43
Domestic Savings/GDP	13.41	19.17	23.62	33.25	32.17
Gross Fiscal Deficit/GDP		7.81	7.91	6.21	7.95
Current Account Deficit/GDP	-0.87	-1.76	-0.70	-0.32	-3.36
WPI Inflation	5.70	8.65	6.49	5.55	7.54
Buoyancy					
Trade (Import and Export)	1.13	1.10	1.46	1.74	1.35
Domestic Savings	1.36	1.05	1.17	1.58	0.72
Gross Capital Formation	1.42	1.06	1.12	1.73	0.88
Non-Food Credit		1.16	1.17	2.01	1.04
Incremental Capital Output Ratio (Ratio of GCF to GDP/Growth of GDP at factor cost)					
Gross Capital Formation	4.14	4.02	4.13	3.87	5.02
Gross Fixed Capital Formation	3.87	4.00	3.94	3.41	4.44

Source: Calculation based on Central statistical Office Press Notes

5. Many factors contributed to the acceleration in growth in phase IV. There was sharp increase in the ratio of gross capital formation (GCF) from 24.4 per cent of GDP in phase III to 33.6 per cent of GDP. The increase

in GCF was largely domestically funded with domestic savings also moving up from 24.2 per cent of GDP in phase III to 32.5 per cent. There was also a sharp increase in the ratio of trade to GDP from around 23 per cent in phase III to close to 40 per cent. The trade buoyancy during this phase reached 1.74, which is the highest recorded in the five phases. Growth also got support from a supportive monetary and credit policy. The buoyancy of non-food credit was 2. Higher savings and a faster credit growth facilitated expansion of capacity in real and services sectors. While fiscal deficit of general government (combined deficit for the Union and the States) remained elevated at 6.2 per cent of GDP, it was still the lowest. Economy also better utilised the capital with implicit incremental capital-output (ICOR) ratio declining from 4.13 during 1992-2003 (phase III) to 3.87 in phase IV.

6. The period 2008-13 continued to witness an increase in the ratio of GCF to GDP, which improved by over 2 percentage points, the higher GCF was largely due to external flows. International trade (both imports and exports), though continued to increase at rates faster than GDP, trade buoyancy significantly declined. There was a sharp reduction in credit growth with monetary policy becoming more restrictive as emphasis shifted to containing inflation. Inflation measured in terms of the Wholesale Price Index increased by over 200 basis points during this period. There was an increase in general government's fiscal deficit as stimulus measures had to be undertaken to insulate growth from global melt down. While there was an investment build up, the efficiency in use of capital, proxied by inverse of ICOR, declined. ICOR increased to close to 5 indicating that for each unit of output 5 units of capital were needed. Quarterly GDP data (Fig 1) also confirm that the squeeze in growth had more been due to an increase in implicit ICOR.

7. A moderation in GDP growth in recent years, more particularly from 2011-12 onwards, has been due to a combination of factors which impacted on capital formation, savings, credit flow and an increase in ICOR. While moderation in the growth of capital formation and savings could largely be due to moderation in growth itself, as a supply sector phenomenon, increase in ICOR reflected increase in capital intensity in economy and to an extent increase in work in progress. The sectoral ICOR data summarised in Table 2 clearly reveals that ICOR witnessed a sharp increase in all the major sectors.

Table 2: Incremental Capital Output Ratio

Growth Phases	I	II	III	IV	V
In per cent	**1950-51 to 1979-80**	**1980-81 to 1991-92**	**1992-93 to 2002-03**	**2003-04 to 2007-08**	**2008-09 to 2012-13**
Gross Capital Formation$ (GCF) as per cent to GDP (at factor cost) of the Sector					
Agriculture	7.38	8.70	10.38	13.82	16.51
Industry	38.30	48.77	46.77	64.07	55.57
Services	18.68	22.95	23.54	28.75	32.63
Infrastructure$	59.81	61.59	42.36	41.57	57.92
ICOR					
Agriculture	3.45	2.26	3.84	2.84	5.18
Industry	7.34	8.68	7.85	6.58	9.28
Services	4.25	3.62	3.07	3.03	3.74
Infrastructure	9.43	9.32	5.05	3.58	5.90

$ Covers Electricity, Transport, Storage and Communication segments
Source: Calculation based on Central statistical Office Press Notes

8. Slowdown of the economic activity in last three years has raised the issue whether this slow-down is an aberration or a new growth potential. This also raises the issue whether it would be possible to get back to a growth of 8.5 per cent and above. Normally, potential growth is measured using trends and filters like the H-P. In one sense, these are backward looking measures, since they depend on historically observed data. In the case of measuring capacity utilization, the maximum capacity is very often taken as the maximum output achieved in the recent period. Studies, however, indicate the potential growth to have moderated to an extent, but whatever measure we adopt, the observed growth in last 12 quarters is lower than the potential growth.

9. Besides the issue of efficiency and competitiveness, moving to an accelerated growth path would require step up in investment which remain a major determinant of growth on account of paucity of infrastructure and manufacturing capacities. To assess whether we will be able to get back to the high savings and investment rates of the previous period, we need to look a little more closely at some of the macroeconomic parameters, particularly the savings and investment (Table 3) during recent low growth phase.

Table 3: Domestic Savings & Investment (as per cent to GDP at current prices)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Difference
Gross Domestic Savings	**36.82**	**32.02**	**33.69**	**33.68**	**31.35**	**30.09**	**6.73**
Household Sector	22.42	23.64	25.18	23.13	22.81	21.88	0.54
Financial Assets	11.63	10.14	11.96	9.94	7.02	7.09	4.54
Physical Assets	10.79	13.50	13.22	13.18	15.79	14.79	-4.00
Private Corporate Sector	9.40	7.41	8.35	7.97	7.31	7.05	2.35
Public Sector	4.99	0.96	0.16	2.59	1.24	1.17	3.82
Gross Capital Formation	**38.11**	**34.30**	**36.48**	**36.50**	**35.52**	**34.82**	**3.29**
Public Sector	8.86	9.44	9.15	8.43	7.72	8.13	0.73
Private Corporate Sector	17.31	11.30	12.14	12.82	10.14	9.15	8.16
Household Sector	10.79	13.50	13.22	13.18	15.79	14.79	-4.00
Gross Fixed Capital Formation	32.92	32.35	31.74	30.92	31.76	30.37	2.55
Construction	18.17	18.15	17.79	17.17	17.73	17.51	0.66
Machinery & Equipment	14.75	14.19	13.95	13.75	14.03	12.86	1.89

Source: Calculation based on Central statistical Office Press Notes

10. The gross domestic savings rate fell by 6.7 percentage points between 2007-08 and 2012-13. However, the decline in the investment rate was less. It fell from 38.1 per cent in 2007-08 to 34.8 per cent in 2012-13 which is a decline of 3.3 percentage points. The investment from private corporate sector recorded a sharp fall of over 8 percentage points.

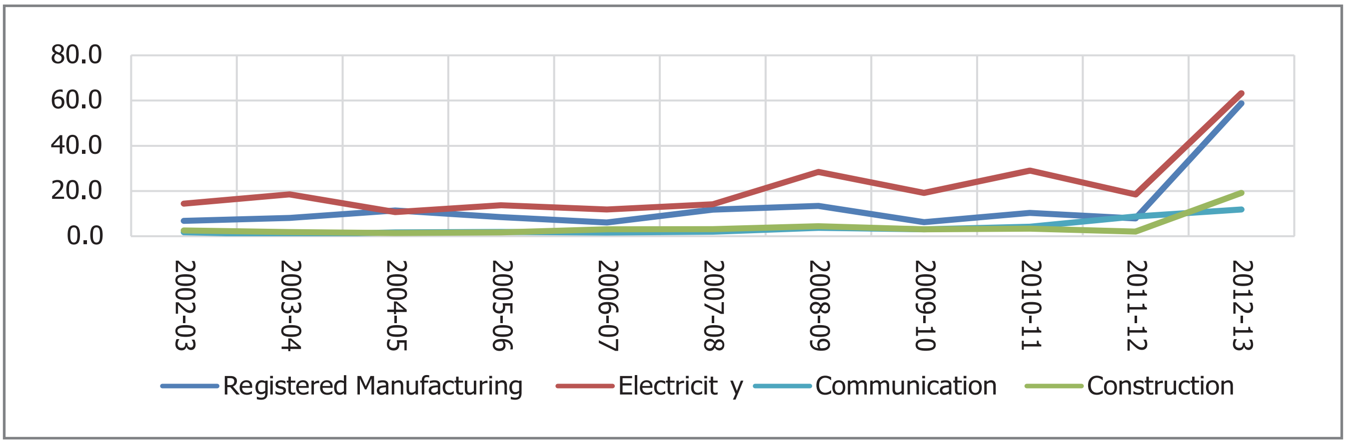
11. Looking at the domestic savings rate, of the decline of 6.7 percentage points, more than half was contributed by the decline in public sector savings. During this period, the fiscal deficit rose sharply. Within household savings, there was a sharp decline in the ratio of savings in financial assets to GDP by 4.5 percentage points, mostly due to high inflation. Private corporate sector also saved less as high inflation and poor demand has adversely affected their margins.

12. An increase in the ratio of consumption to GDP in 2011-13 with no commensurate decline in capital formation resulted in a decline in the level of aggregate savings relative to GDP and also in widening of the current account deficit (CAD). Higher CAD made it possible to have higher investment over and above what domestic savings could permit. It would, therefore, not be entirely correct to say that the widening CAD moderated the growth in the short run, even though it exerted pressure on both the exchange rate and inflation.

13. An increase in implicit ICOR in last three years may partly be due to a structural shift in investment. The ratio of gross capital formation to GDP for the private corporate sector declined from 17.3 per cent in 2007-08 to 9.2 per cent in 2012-13. This could be due to the expectations of lower growth in the aftermath of global crisis making corporate sector to postpone investment and also perhaps as some investment made earlier was yet to come to production stream. The decline in the investment by the private corporate sector was also sharper than a decline in their savings or internal accruals indicating that the transfer of resources from household sector, directly or through intermediation by the banking institutions, declined.

14. Due to sharp moderation in the growth of electricity and registered manufacturing, an increase in ICOR of these sectors phenomenal (Fig 3). Such an increase in ICOR is clear indication of large work in progress and existence of completed or nearly completed projects still shifting to commercial production. In electricity sector, nearly 16,000 MW of capacity was reportedly idle because of an absence of the coal supply linkages.

Fig 3: ICOR of Certain Sectors



15. Decline in savings of private corporate sector is largely explained by a decline in their profitability. With economic growth persisting below the potential for nearly 12 quarters now, there has been erosion in the pricing power of producers/distributors. High inflation combined with an increase in the cost of capital affected the internal accruals and profitability of the corporate sector (Table 4). The squeeze in the profit margins of companies was particularly sharp for small and medium sized companies.

Table 4: Net Profit Margins for the Corporate Sector (per cent)

	2010-11		2011-12		2012-13		2013-14
	H1	H2	H1	H2	H1	H2	H1
Number of Companies	**2,576**	**3,075**	**2,643**	**3,063**	**2,832**	**2,912**	**2,731**
All Companies	8.6	8.2	6.7	6	6.4	6.5	5.2
Companies with annualized sales exceeding Rs.10 billion	9.2	9.2	7.4	6.7	7.0	7.8	5.9
Companies with annualized sales between Rs.1-10 billion	6.6	4.8	3.7	3.2	3.5	0.5	2.1
Companies with annualized sales below Rs.1 billion	0.4	-4.9	-0.8	-3.4	-4.O	-15.0	-7.7

Source- Reserve Bank of India- Monthly Bulletin-February, 2013

16. Data from the Annual Survey of Industries (ASI) also confirm erosion in margins for the organised manufacturing sector (Table 5) with profit as percentage to gross value added declining continuously over last five years.

Table 5: Components of Value Added for Organised Manufacturing Sector (per cent)

	Ratio of Gross Value Added to Output	Components of Value Added				
		Employee Compensation	Depreciation	Interest	Profit	Others
2007-08	19.9	19.1	12.9	9.3	53.8	4.9
2008-09	18.7	21.2	13.7	11.2	48.6	5.3
2009-10	18.7	21.1	15.1	10.5	47.8	5.6
2010-11	17.8	22.0	14.5	10.6	47.8	5.2
2011-12	16.9	22.0	14.4	12.4	39.9	11.3

Source- Annual Survey of Industries, various issues

17. Economic growth is a function of expectations, investment and efficiency. While efficiency is partly internal to economic agents, Government can improve expectations and create enabling environment for investment. One of factors which have affected manufacturing investment is the high cost of capital. With pricing powers of the corporate having declined considerably, high cost of capital has affected their internal accruals.

Interest rates have also acted as a dampening factor for demand for consumer durables. With exchange rate largely market determined and prices of tradable being governed by the landed costs, high interest rate has acted as one of the major constraining factors.

18. Besides interest rates, the measures which could increase investment and reduce the bottlenecks for industry could be of two types, the first one relating to infrastructure and second to the regulatory environment.

19. Infrastructure: Major areas of actions could be the following:

- Several manufacturing projects have been unable to take off due to non-availability of critical inputs such as coal and power. These sectors are affected by regulatory and procedural issues that need to be sorted out.

- There needs to be a continued focus on achieving production and capacity creation targets in basic infrastructure sectors like coal, power, road and railways, most of which are directly under government control, which could generate the base for achieving higher growth.

- The DMIC is the most ambitious infrastructural programme in recent times with the objective of expanding India's manufacturing and services base. Apart from Eastern and Western Freight corridors, pre-feasibility studies have been completed for four future freight corridors i.e. East-West corridor (Kolkata – Mumbai), North– South corridor (Delhi – Chennai), East Coast corridor (Kharagpur–Vijayawada), and Southern corridor (Goa – Chennai). Timely completion of these projects would be of immense value to manufacturing sector.

- Since India has a huge and growing energy deficit, this sector needs special interventions. We need to insulate pricing of these utilities from the administrative and other concerns. Even if there is a need for subsidising the products for a class of users it should be provided transparently rather than through cross subsidisation or by affecting internal accruals of the producers/service providers.

20. Regulatory and governance environment: India is generally considered a difficult country to do business in, owing both to laws that have multiple interpretations and their lax implementation. This image needs to change. Some of clearances relating to land and environment could be obtained earlier in the form of an investment zone or before the project is put for bidding.

21. Domestic savings are not showing the buoyancy which it had witnessed earlier. While a squeeze in real incomes due to lower growth and persistently high inflation could be main factor, financial savings of the household sector could be incentivised.

- A differential treatment is accorded for income on account of interest and on account of dividend, though both are the income from investment. While it is true that dividend is taxed at the level of the company and it may amount to double taxation if that is taxed again with the receiver. But in India, most risk-averse investors still prefer the security of a Fixed Deposit as a safer investment options. Investors in equity are active investors while investors in FD are passive investors, but both these provide investible resources, directly in case of equity and indirectly through the institutional intermediation and deserve a similar treatment.

- There has been a sharp increase in ICOR of the construction sector. This may partly be due to large inventories of housing stock and due to the affordability issue. First time home buyers have some preferential treatment. With the cost of housing having gone up substantially, there has been an increase in interest burden. There is a need to either provide concessional finance for housing, at around bank rate, or a higher set off for tax purposes. Further, the credit for houses is restricted to 80 per cent of the cost. For first time buyers, who may have entered the job market only recently, arranging own funds to 20 per cent is difficult. With house prices continuously witnessing an increase, the worth of the collateral is always increases, raising this limit will not make the credit riskier.

- It should be understood that majority of Indian household are first time buyers of many consumer durables resulting in a limited replacement demand. Any incentive to housing sector, in a way is incentivising the sectors producing consumer durables. This sector has been witnessing a negative growth for last consecutive 17 months.

22. Expectations drive the investment and these are sustained based on a credible and predictable policy regime. Policy uncertainties and apprehensions dampen expectation and impede growth. Even when macro fundamentals are strong, if expectations are not buoyant, investment may remain sluggish and could be delayed.

Containing Inflation- Options

23. The years 2010-13 witnessed a persistently high level of inflation, particularly for food products. The Wholesale Price Index (Table 6) continued to show a wide gap (which seems narrowing lately) between food and non-food inflation. Persistently high inflation constrained the central bank to adopt a more restrictive credit and a tighter monetary policy than what the declining growth rate warranted, as monetary policy simultaneously affects aggregate demand and the cost of capital. Further with a decline in the pricing power of the corporate sector and profitability, it also raised the demand for restructuring of loans and non-performing assets of the banks. The quality, quantity and price of credit were adversely affected.

Table 6: Wholesale Price Inflation- Major Commodity Groups (per cent)

	2010-11	2011-12	2012-13	2013-14				2014-15
				Q1	Q2	Q3	Q4	Apr-May
All Commodities	9.56	8.94	7.35	4.84	6.63	7.05	5.38	5.60
Food items	11.10	7.24	9.28	7.71	11.82	11.94	6.22	6.66
Non Food items	8.98	9.59	6.63	3.74	4.61	5.16	5.06	5.19
Non-food Manufacturing Products (Core inflation)	6.11	7.29	4.87	2.58	2.36	3.08	3.74	3.62
Protein Food	19.78	10.32	11.36	7.34	6.95	7.49	7.88	9.09
Gap between inflation of different commodity groups								
Food-Non-Food	2.12	-2.35	2.65	3.97	7.21	6.78	1.16	1.48
Food-Headline	1.54	-1.70	1.93	2.87	5.19	4.89	0.84	1.06
Headline-Core	3.45	1.65	2.48	2.26	4.28	3.97	1.64	1.98
Food-Protein food	-8.68	-3.08	-2.08	0.37	4.87	4.45	-1.66	-2.43

24. Not only had the food inflation persisted during this period, drivers of inflation have continued to shift making the task of containment of inflation somewhat difficult (Table 7). Besides the changes in the dietary habits which raised the demand for these products relative to their supplies, seasonal fluctuations and supply shocks contributed to high and fluctuating prices of vegetables.

Table 7: Contribution to Food Inflation (per cent)

		Cereals	Pulses	Vegetables	Fruits	Dairy/Animal Products	Sugar	Edible Oils
2010-11	H1	8.56	4.00	2.57	12.02	51.86	4.97	1.50
	H2	5.70	-3.51	16.69	18.63	46.53	-10.66	10.68
2011-12	H1	8.40	-2.59	4.36	24.56	29.99	4.74	15.63
	H2	8.88	9.92	-67.04	12.46	101.29	7.27	24.89
2012-13	H1	13.38	8.39	22.58	-4.00	36.78	7.87	11.19
	H2	26.71	6.06	4.02	6.10	25.14	9.61	8.04
2013-14	H1	24.41	-0.47	26.14	2.05	24.29	2.54	-0.37
	H2	17.99	-3.02	27.68	11.71	33.94	-5.49	-1.08
2014-15	Apr-May	17.92	-0.02	0.24	23.06	43.38	-1.91	-0.98

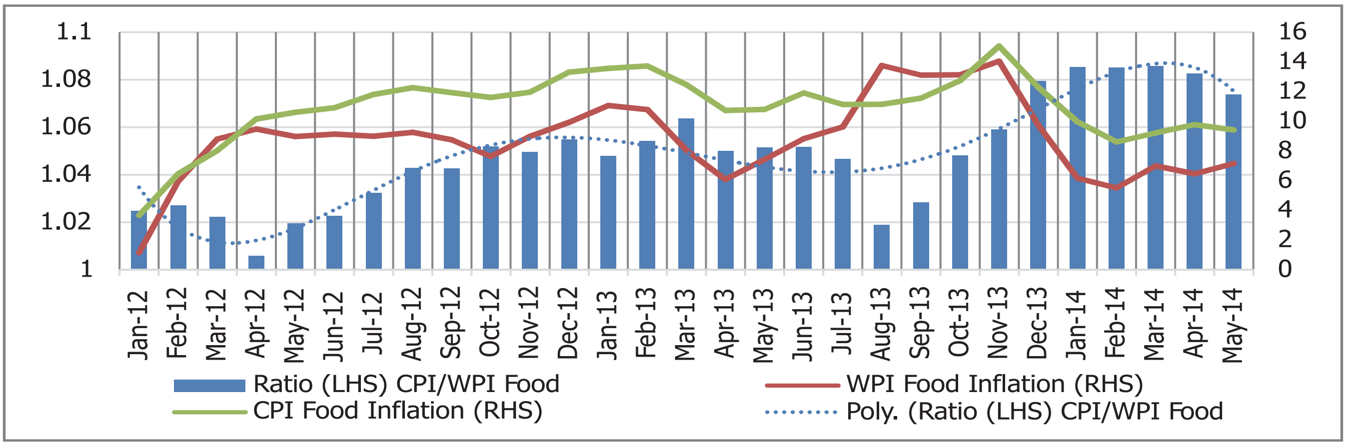
25. In contrast to the domestic inflation, the global economy is currently characterized by benign price regime. In open economies, with no trade restrictions, domestic prices of tradable products usually converge to their export or import parity prices. Since Indian food prices are lower than international prices, there is no similar moderating influence on food inflation. The close association of domestic and global prices is therefore

reflected in a moderate non-food manufacturing inflation, defined as core inflation. Since food inflation has shown a declining tendency of late, overall, inflation has witnessed moderation in Jan-Feb, 2014 to around 5 per cent. However, with bottoming out of the seasonal decline in vegetable prices, inflation is again hovering around 6 per cent.

26. Urjit Patel Committee constituted by the Reserve Bank of India has recommended that the nominal anchor should be defined in terms of headline CPI inflation, which closely reflects the cost of living and influences inflation expectations relative to other available metrics[1]. According to the Committee, the WPI is not only an imperfect substitute for a producer price index (PPI), it does not capture price movements in non-commodity producing sectors like services. Further, the WPI is often subject to large revisions which generate large uncertainty in the assessment of inflation conditions.

27. Retail prices measured in terms of the Consumer Price Index (CPI-New Series) continued to remain higher both at the aggregate level and for the food segment of commodities. The ratio of CPI and WPI food index converted to a common base (2010=100) with more or less a common basket, continued to increase. The inflation gap started widening from April 2012 and except for three months in Aug-Oct 2013, continued to persist. Increase in the ratio of the two indices with a common base indicates that either transmission of wholesale prices to consumers was delayed or there was a tendency to protect margins (Fig 4).

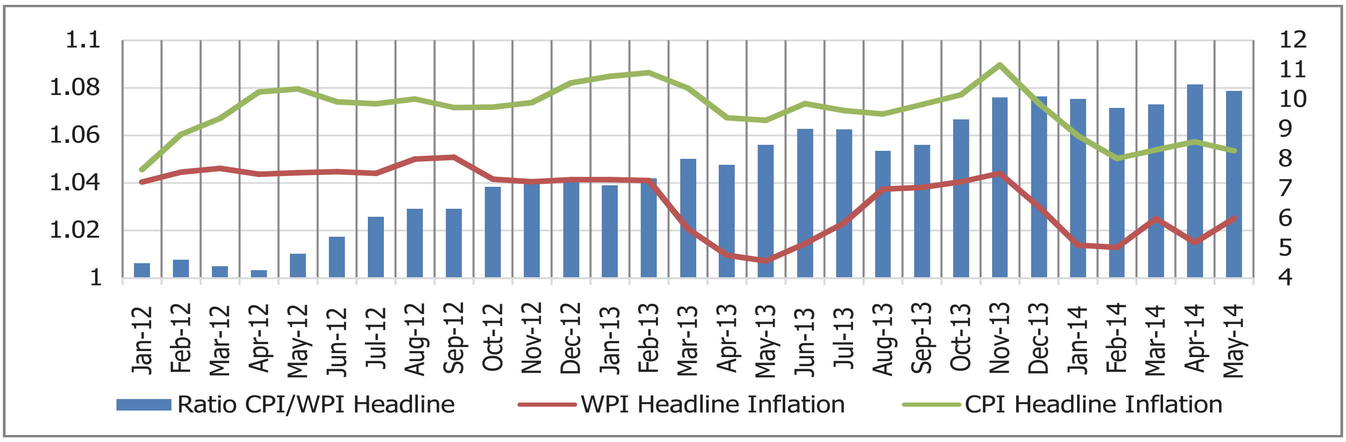
Fig 4: Ratio of CPI/WPI Food Index and inflation



Source- CSO and Office of Economic Adviser

28. Gap between headline WPI inflation and overall CPI inflation was even larger and has continued to persist (Fig 5). Persistently high food inflation also has a tendency to get generalised through wage price increases and the same is reflected in high CPI inflation. This in turn affected the investment and output growth in non-farm segments of the economy.

Fig 5: Headline WPI and CPI Inflation

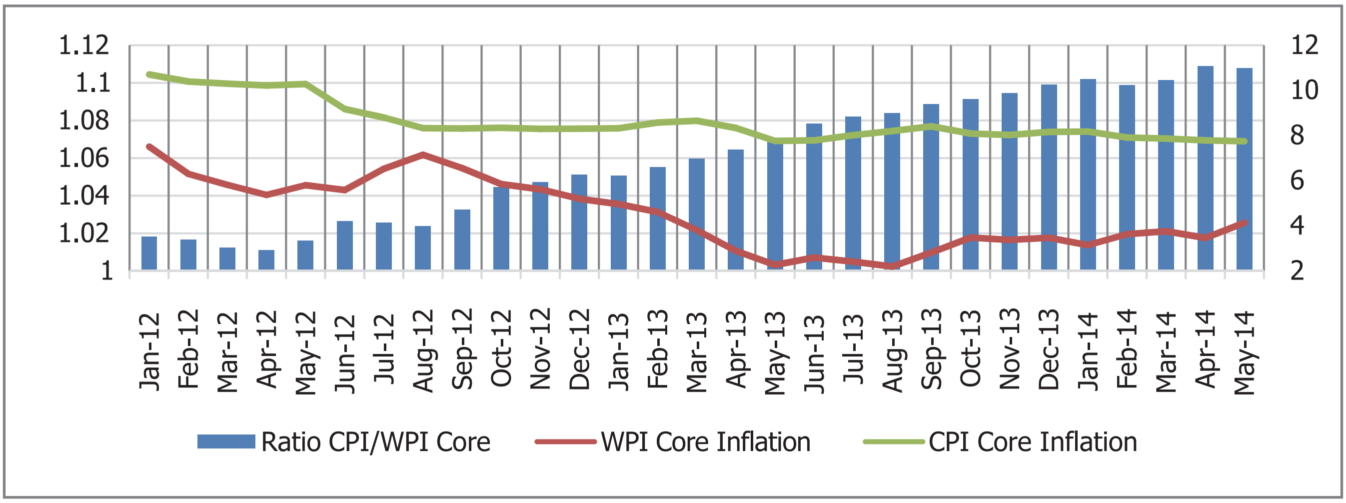


Source: Calculation based on Central statistical Office Press Notes

[1] *Report of the Urjit Patel Committee*

29. Food inflation is often considered difficult to contain through the monetary policy instruments. These commodities with usually a stable demand and in part are non-tradable are more responsive to supply shocks (both positive and negative). It is, therefore, more common to look at the core inflation (non-food and non-fuel) as a parameter for monetary policy interventions. However, even in case of core, WPI and CPI do not show any sign of converging. While WPI core is moderating since August, 2012, CPI core inflation remains generally sticky at around 8 per cent (Fig 6). Though the commodity basket for core CPI and WPI differ significantly, WPI core appears to follow the global non-energy non-food prices, but CPI-core indicate more of a spill over of food inflation.

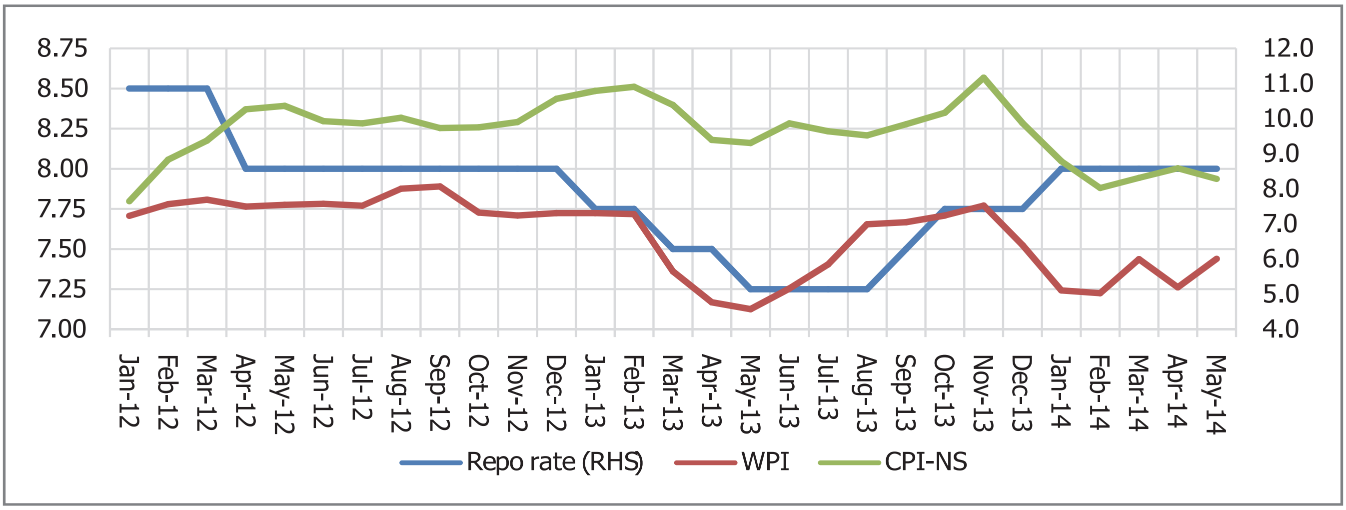
Fig 6: WPI and CPI Core Inflation



Source: Calculation based on Central statistical Office Press Notes

30. Reserve Bank of India continued to use the monetary policy instruments to contain inflation and anchor inflationary expectations with somewhat limited success (Fig 7). Time lags in transmission of monetary policy are long and variable and tend to differ from one country to another owing to differences in economic and market structures. For instance, these lags are found to vary from 1-14 quarters for transmission of policy rates to output across a gamut of advanced and emerging economies with varied monetary arrangements[2]. The broad consensus emerging from various studies indicate that monetary policy in India impacts output with a lag of about 2-3 quarters and WPI headline inflation with a lag of about 3-4 quarters and the impact persists for 8-12 quarters.

Fig 7: Changes in Repo Rates and Headline WPI and CPI-NS inflation



Source: Calculation based on Central statistical Office Press Notes

[2] *Report of the Urjit Patel committee*

31. However, sustained fiscal dominance reflected in large borrowing programs of the State with intermittent use of open market operations to manage yields, pre-emption of banking resources through statutory liquidity ratio, policy insulated interest rate structure for small savings, large informal sector and money and credit market frictions constrain the transmission of monetary policy instances to output and prices. Further, it is generally accepted that monetary policy has limited effects on aggregate supply or productive capacity. In the presence of credit constraints, the ability of firms to expand capacities is actually impacted adversely which may further widen the demand supply gap. Erosion in the profitability as indicated in Table 5 partly due to weak pricing power together with a tight monetary policy stance led to a sharper and prolonged contraction in aggregate supplies relative to demand and a stable inflation regime is yet to emerge.

32. Long term trends of inflation in India indicate that supply side factors like drought, global uncertainties, war and international commodity price have been the major reasons behind inflationary spikes in India. In the past 20 years, weighted contribution of food and fuel group of commodities to overall inflation has exceeded the combined weight in 16 years. Inflation has therefore, more of a structural nature arising largely due to supply shocks or getting transmitted through an upsurge in global commodity prices. Persistent food inflation, however, usually gets generalized through a wage-price spiral and through build-up of expectations.

33. Though the RBI's monetary policy stance has remained focused on the twin objectives of containing inflation and facilitating growth, inflation management has had an overriding objective. This has led to a sharper slowdown of economy than anticipated. Further, with a significant part of inflation getting generated because of poor supply responses, a shift in policy stance of RBI coupled with improving access of credit with moderation in its cost would be desirable.

34. Persistence of inflation is due to food inflation. Even in case of non-food or core CPI inflation, persistence can be visualised as a lagged effect of food inflation. **A number of measures could be considered.**

    ◈ Improving supply chain logistics in agricultural marketing by setting up cold chains and processing facilities in producing clusters to reduce wastage will considerably reduce the gap between the prices that a consumer pays and that producers receive. Studies have shown that in most perishable products, the price spread is nearly 50 per cent. This is an economic waste with neither the producers nor the consumer getting any benefits.

    ◈ Liberalizing agricultural trade by modifying Agricultural Produce Marketing Committee (APMC) Acts which restricts competition and also fails to provide appropriate price signals to the producers is another step that may be necessary.

    ◈ Productivity improvement through contact farming, leasing of farm land and revival of extension support at the farm level needs consideration.

    ◈ It should be understood that reduction in inflation may not happen simply by reducing the prices which are received by the producers. Higher MSP or market prices for products not covered by MSP provide incentive to the producers. In the absence of productivity gains, these are the only incentives. Attempt should be reduce the wastage and improving supply logistics.

    ◈ One of the major challenges of the economy today is lower agricultural growth and low investment in this sector. With small holdings and fragile financial conditions of the farmers, it is difficult to increase investment in agriculture. We may, therefore, need to consider, like in industries, a cluster approach with common facilities be provided through the cluster. It could have the facilities for soil testing, land levelling, managing water channels or drip irrigation systems, grading and sorting facilities for perishable products like fruits and vegetables and other facilities as the cluster management may consider appropriate.

Improving the employment opportunities

35. In recent years, GDP growth in India has generally not been able to increase jobs. Workers participation in population declined to 38.6 per cent during 2011-12, the lowest so far. The decline has largely been due to lesser number of rural female participating in workforce. This decline to an extent in due to females in age group 15-25 opting to education and skill development and joining labour force a little later. However, it is

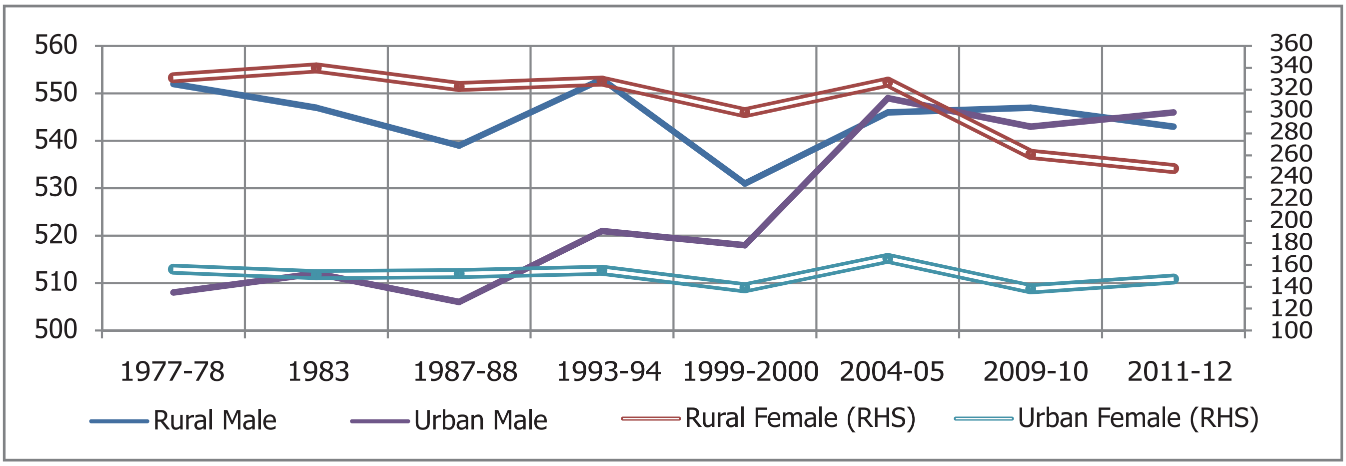
important to identify other factors. This, nonetheless, signifies the need for MGNREGA kind of programmes providing some employment guarantee (Table 8 & Figure 8).

Table 8: Worker Participation (per 000 of population)

NSSO rounds	Rural			Urban			Total		
	Male	Female	Persons	Male	Female	Persons	Male	Female	Persons
1977-78	552	331	444	508	156	341	543	297	423
1983	547	340	445	512	151	340	538	216	420
1987-88	539	323	434	506	152	337	531	285	412
1993-94	553	328	444	521	155	347	545	286	420
1999-2000	531	299	417	518	139	337	527	259	397
2004-05	546	327	439	549	166	365	547	287	420
2009-10	547	261	408	543	138	350	546	228	392
2011-12	543	248	399	546	147	355	544	219	386

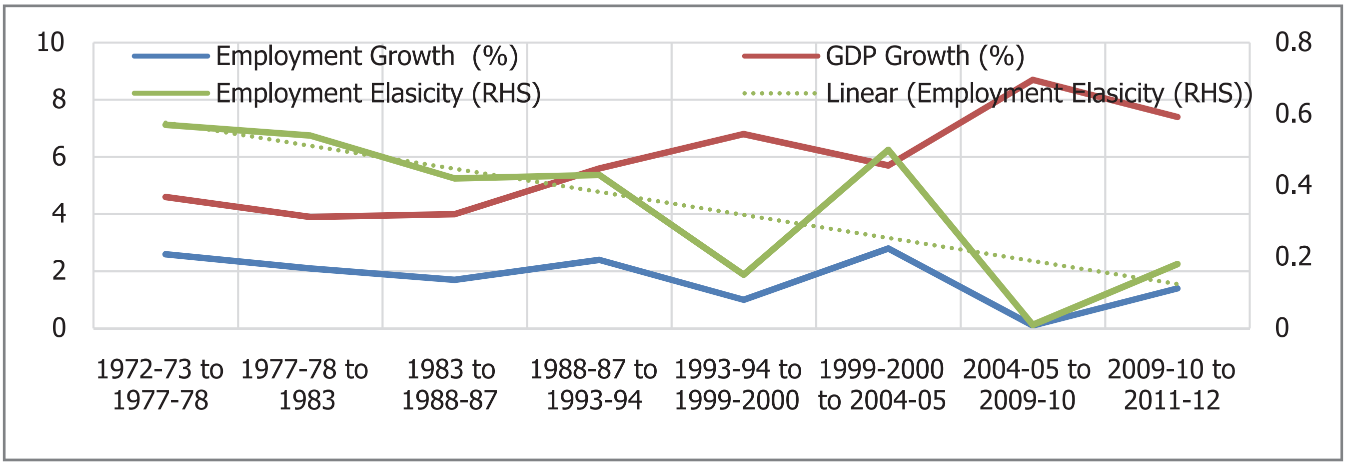
Source: NSSO Reports

Fig 8 – Workers Participation Rate (000 of population)



36. Using compound average annual rate of growth approach, Reserve Bank has calculated employment elasticity of Indian economy for the NSSO survey periods from 1977-78 (Fig 9)3. Employment elasticity declined to 0.01 during 2004-05 to 2009-10 period. The high growth during this period was in fact a job less growth.

Fig 9: Employment growth and employment elasticity



[3] Reserve Bank of India, Working Paper, 6/2014

37. MGNREGA, however, could be restructured in a manner that it creates productive assets and improve productivity of agriculture. It should be conceived as a temporary measure and should not make the mainstay of any state sponsored employment generation. Though there is no conclusive evidence, but both the farming and manufacturing sector have been complaining that MGNEREGA has raised the threshold level of wages in rural areas affecting their returns. The programme could be increasingly used for skill development for meeting critical skill gaps.

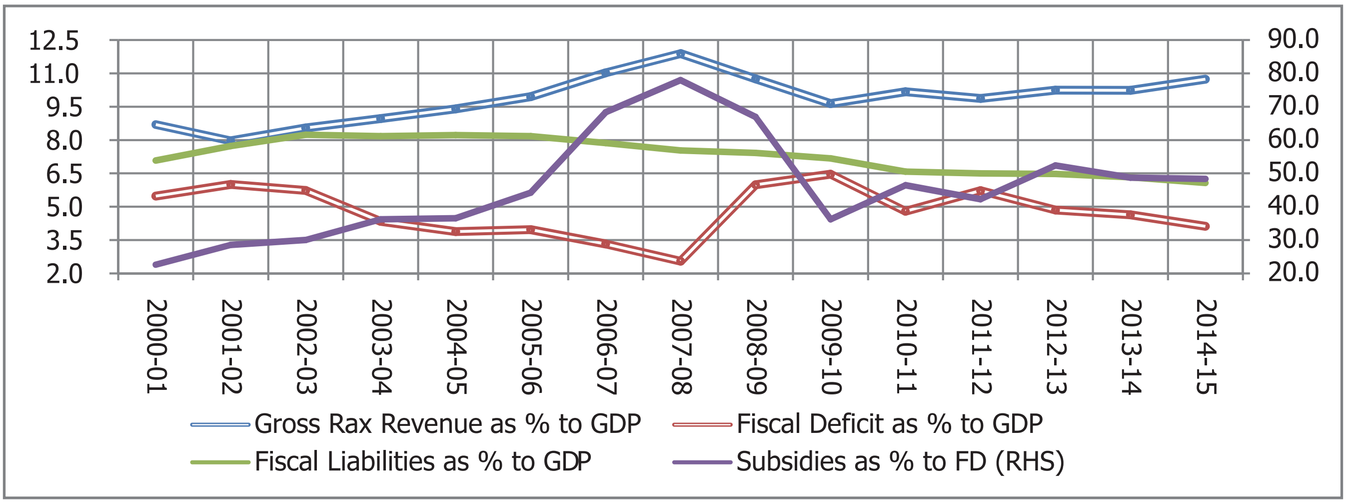
38. As per the new manufacturing Policy, the country seeks to boost manufacturing growth and improve its share of GDP from the present 15-16 per cent to 25 per cent by the next decade. The target is to create 100 million jobs by 2022. A number of concrete steps need to be taken to ensure this.

- Given India's comparative advantage, there is a need to put in place a policy regime that is at least neutral between labour and capital.
- Other factors constraining manufacturing investment, such as policies for acquiring land, unpredictable implementation of tax laws, cumbersome exit structures, also need to be addressed.
- Manufacturing, particularly the small scale manufacturing needs to be profitable. Studies show that the manufacturing establishments have a variety of statutory obligation to discharge which are costly, time consuming and often ineffective in meeting their stated objectives. Besides reducing the compliance through self-certification, consolidation of returns and their reduced periodicity, automatic greening, there is need to conceive an alternate institutional mechanism. A new service entity, specifically created to take on the responsibility of meeting statutory obligations, and expected to be more efficient, economical and better equipped to serve the interests of both the employers and the employees could be envisaged. The entity could be a (publically created) commercial entity and could charge a fee/ subscription, linked to wage bill of the industry for its services so that it maintains enough liquidity and be solvent for its day to day needs.
- Within manufacturing, there is a need to shift structurally in favour of high value addition industries. Specific policy thrust is required in high precision machinery, pharmaceuticals, bio technology, ship building, defence production, aero-space industry are some of the areas which provide scope for diversification. Considerable and growing domestic demand in many of these sectors has to be leveraged for locating production. It can provide depth to Indian manufacturing while increasing value addition from this sector. These sub-sectors are also research and technology intensive with significant backward linkages. No major equipment manufacturer, be it for defence platform or heavy machinery, has in-house facilities for manufacture of all components or sub systems. System integration is the key area where India has ample scope to expand, leveraging its technical education and existing production base.
- Another feature of employment in non-farm sector relates to missing middles. While growing casualization of workers in the organised sector is one manifestation of this phenomenon, lack appropriate soft skills in the other one. Though employment opportunities have been created at lower levels- security guards, data entry operators, shop floor managers, plumbers, etc., the middle level jobs or the jobs which would guarantee a regular increment (upgradation) has been missing. This trend needs to be reversed through appropriate measures.
- While skill development and imparting skills in partnership with industry has already been initiated, there exists a considerable mis-match between the skill sets that are in demand and skill sets that are available. Many of our technical persons are found unemployable by industry requiring some kind of retraining. We are yet to fully exploit the apprenticeship route for industrial employment.
- A possible synergy could be established between skill development and MGNREGA. MGNREGA should lead to either long term physical assets creation or human resource development through demand based skill upgradation. Release of funds for zero material component projects under the scheme should be discontinued as these may perhaps be pure cash doles. Maintenance of the ratio of material and labour component should be observed at district level to provided project to project flexibility. Similarly, allocation for building project preparation capacity at the district level may need to be increased to a minimum of 10 per cent.

Fiscal Consolidation

39. An important feature of our fiscal system is a near stable tax/GDP ratio for the central taxes. Tax/GDP ratio, after peaking to a level of 11.9 per cent in 2007-08 has stabilized at a level little over 10 per cent. With a buoyancy of gross tax receipts barely 1.1, the entire burden of fiscal consolidation needs to be borne by either an expenditure contraction or through a sale of publically held assets. The empirical results on size of multipliers, based on an RBI study seem to indicate that fiscal consolidation through increase in tax revenue rather than reduction in expenditure may have less contractionary effect on GDP4.

Fig 10: Fiscal Parameters- A snap shot view



Source- Calculation based on Budget papers and CSO, data for 2014-15 are of Interim Budget

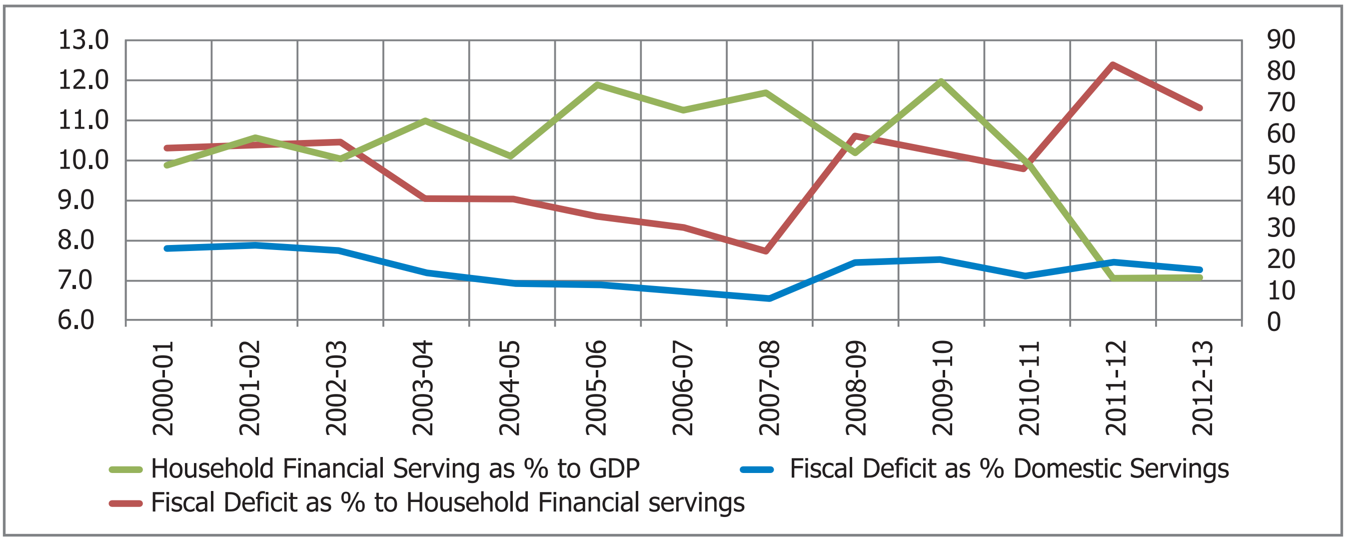
40. It should be appreciated that a significantly graduated schedule of income tax with high penal rates at the top levels is not necessarily the best way to tax incomes either from the point of view of maximizing societal welfare or government revenues. This is because there are complex ways in which progressive taxes impact on incentives to work and save. Therefore, rather than increasing the scheduled rates, much greater attention needs to be placed on widening the tax net. With rates that are moderate and a system that is simpler, it is important to give the signal that any wilful default or evasion would be severely dealt with by a stricter legal system.

41. Possibly the most significant reform measure that the country is still awaiting is the goods and services tax (GST). Owing to a number of historical factors and administrative compulsions there are multiple forms of excise at the central, and sales taxes at the State, levels that lead to cascading, thereby negating the objective of a rational indirect tax system. The complex tax structure undermines efficiency and provides incentives for evasion. An early launch of GST would enable taxation of goods and services in an integrated manner which is required in a modern economic environment.

42. Another implication of our current fiscal stance is pre-emption of domestic savings (Fig 11) by Government. Fiscal deficit, which represent the net new borrowing by the Centre were close to 20 per cent of total domestic savings and nearly 70 per cent of financial savings of the households. Such a large pre-emption, partly through the Statutory Liquidity Ratio (SLR) reduces the need for the banks to look for other borrowers to that extent.

[4] *RBI Working Paper 7/2013*

Fig 11: Pre-emption of Savings by Central Government



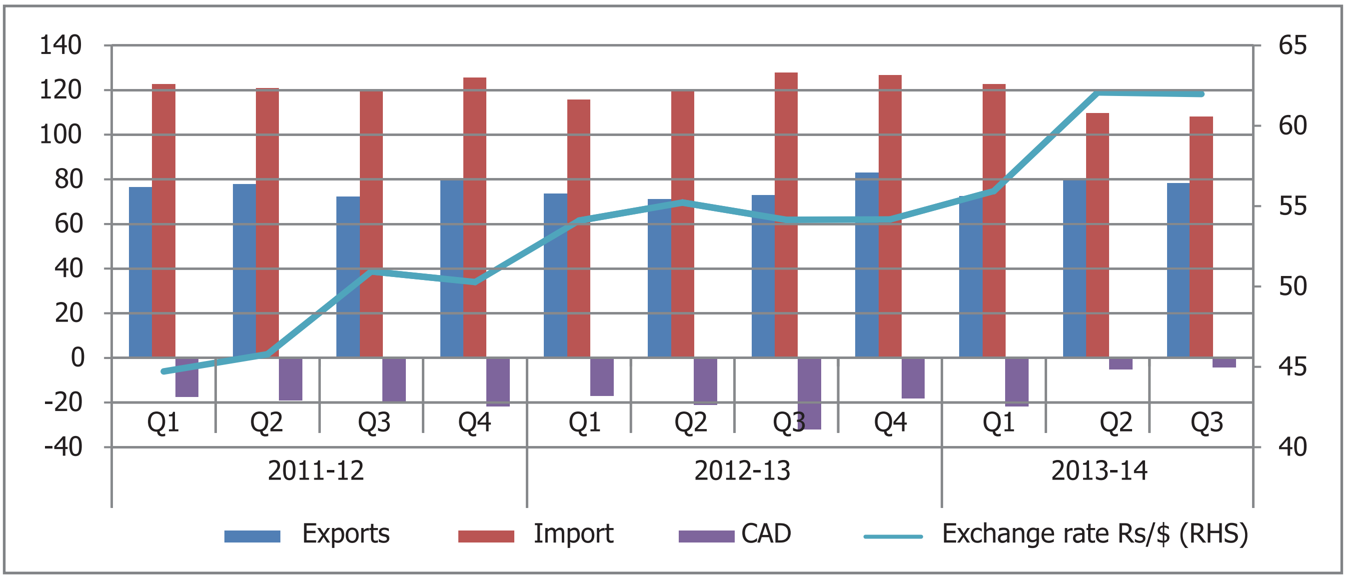
Source: Calculation based on Central statistical Office Press Notes and Budget papers

43. It may be considered to reduce the SLR requirements to 10 per cent of the deposits of the banks. This will impact the system in two ways. First it will release the funds of the commercial banks for manufacturing and infrastructure. Second, it will induce the Government to look to other innovative sources to meet the requirements and compete with the other players.

Missing Export push to economic growth

44. Global economic meltdown had also affected India's exports and severally dented its current account deficit (CAD). CAD remained at unsustainably elevated levels (Fig 12) until Q1 of 2013-14. It was not a surge in imports, but rather a moderation in exports that led to this deterioration in current account. The worsening CAD together with the quantitative easing by US affected exchange rate as well.

Fig 12: External Sector

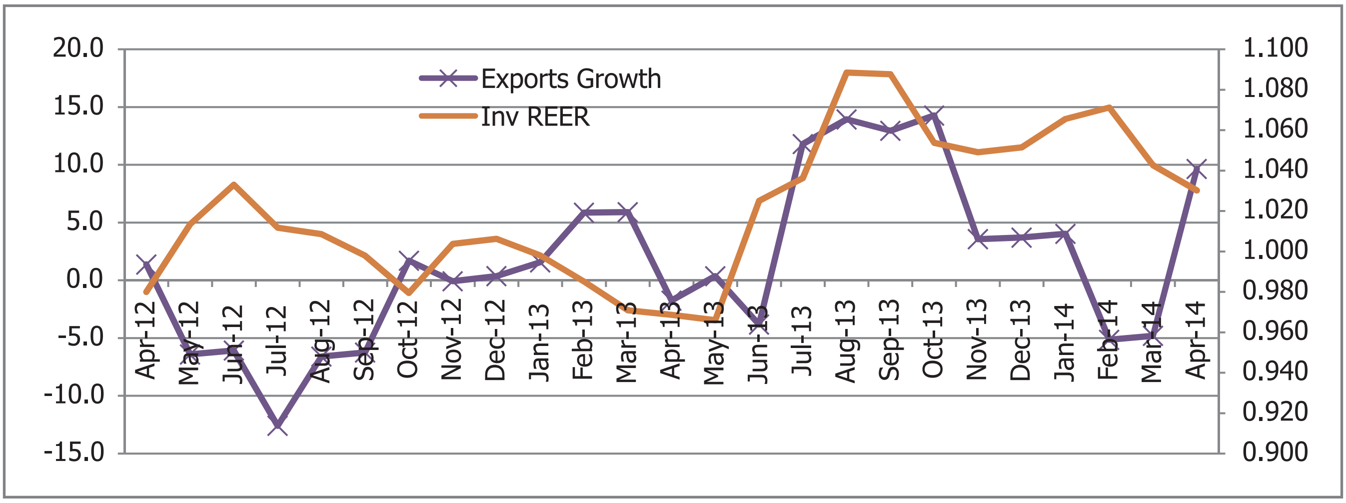


45. Indian rupee, after being range-bound around 46 per USD in the post Lehman crisis period, started depreciating from 2011 and reached to a record low of 68 per USD by end August 2013 becoming the most vulnerable of the five emerging economies'. The RBI introduced two foreign exchange swap schemes in September 2013, one to encourage new foreign exchange deposits into India by non-resident Indians with a minimum term of three years; and one to encourage long-term overseas foreign exchange borrowing by banks which mobilized over USD 34 billion in short run. Reserve Bank also raised short term interest rates

on Marginal Standing Facility in July by 200 basis points and temporarily widened the interest rate corridor to 300 basis points which was later restored back to 100 bps as existed prior to Mid-July. These measures to support currency were successful and rupee reverted to an exchange rate considered aligned to macro fundamentals and has been hovering around 60-62 level for some time now.

46. While some people considered this depreciation as 'debasing of the currency' it did not bring much cheer either to the exporters. This has raised the issue the possible exchange rate push to exports. Many recent studies in Indian context, contrary to the experience of East Asian economies and China, have observed the existence of a positive correlation between export growth, global GDP growth and real effective exchange rate. In a paper 'Impact of Exchange Rate Appreciation on India's Exports' by Veeramani in 2008 also concluded that the appreciation of the REER leads to a fall in the dollar value of India's merchandise exports. However, the degree of the (negative) association between exports and the REER has declined since 2002. A recent policy paper by the Centre for Policy Research, has, however, observed that "merchandise goods exports are helped by weak rupee if the depreciation of exchange rate is sustained over time and its volatility is minimized. India's currency remained considerably overvalued on REER basis from 2012 to first part of 2013 that resulted in a loss of competitiveness of our export sector. First, service exports, the fastest rising component of external earnings and particularly software exports, emerge to be clearly and significantly negatively correlated with exchange rate movements. This finding is substantiated by higher revenues of IT and BPO companies as rupee depreciates. Second, we achieve a statistically significant result when merchandise exports are regressed together (and not independently) with both global growth and currency exchange rate with one year lag. Merchandise exports emerge to be positively correlated to global incomes in the same period but are negatively correlated with the REER with a lag of four quarters5. The export growth of merchandise goods in recent months appear correlated (Fig 13)with inverse of real effective exchange rate (6 Currencies trade based weights with 2012-13 as base) suggesting that a stable and depreciated REER may be desirable for both merchandise and service exports.

Fig 13: Export growth and inverse of Real Effective Exchange Rate



Concerns on Asset Quality in Banks

47. It is a matter of great concern that the gross non-performing asset (GNPA) ratio of scheduled commercial banks in India has been rising steadily in the last few years. GNPAs progressively declined from their elevated levels of the 1990s, with the introduction and further streamlining of prudential regulatory and supervisory norms, through the phase of high economic growth in the early part of the last decade, and right up to the onset of the global financial crisis in 2007-08. Since then, however, the GNPA ratio has been on an upswing, especially over the years 2011-13, with the rise being noticeably pronounced for PSBs (public sector banks).

48. While the GNPA for the priority sector has been consistently and significantly higher than the GNPA in the non-priority sector, in the case of Public Sector Banks (PSB), however, the deterioration in the asset quality in 2012-13 was primarily on account of the non-priority sector. Gross NPAs to Gross Advances rose from

[5] *Centre for Policy Research- Macroeconomics Update May 20, 2014*

2.94 per cent at the end of March 2012 to 3.42 per cent at the end of March 2013, and according to RBI estimates these may increase to 4.4 per cent by end March 2014. The deteriorating asset quality of the banking sector is not only a cause for concern in itself, but it also impacts existing bank capital.

49. The NPAs growth is inversely related to the GDP growth. Low GDP growth translates in to higher NPAs after a lag of one quarter. Empirical estimates reveal that 1 per cent decline in GDP growth leads to rise in NPAs growth by 0.4 percentage points· The disaggregated empirical analysis reveals that NPAs growth is inversely associated with growth in agricultural GDP, with a lag period of six quarters approximately, viz., 1 per cent decline in agriculture GDP causes 1.2 per cent increase in NPAs. The tentative results indicate that acceleration in industrial GDP causes fall in NPAs growth, with a lag of four quarters approximately. The empirical estimates also corroborate the fact that growth in NPAs is likely to go up in the backdrop of elevated interest rate environment, i.e., 100 bps rise in interest rate (money market rate proxy for lending rate) leads to around 0.6 percentage point rise in NPAs growth after a lag of one quarter6.

50. There has also been an increase in debt restructuring. At the aggregate level, the ratio of restructured standard advances to gross advances stood at 5.8 per cent at end-March 2013. It was the highest for nationalized banks (at 8.3 per cent) followed by the SBI Group (at 4.7 per cent). There was a steep rise in the growth of restructured debt under the corporate debt restructuring mechanism, which covers only multiple banking accounts and syndication/consortium accounts where all banking institutions together have an outstanding exposure of Rs.100 million and above in 2012-13. As on June 2013, debt so restructured exceeded Rs. 2.5 lakh crore. The sectors that witnessed the maximum distress were iron and steel, and infrastructure. At end-March 2013, iron and steel accounted for 23 per cent of the total restructured debt, while infrastructure (including power and communications) held an almost comparable share of 22.7 per cent in the total restructured debt7.

51. The present provisioning policy of Indian banks has some drawbacks. The concern is that recoveries have not kept pace with slippages since 2007-08 and, despite write-offs, Gross NPAs have increased. The Reserve Bank of India has proposed various measures to confront the various problems involved in NPA management covering early recognition of stressed assets; modification of restructuring process by getting promoters to bring in more funds and changing management control; accelerated provisioning; and more liberal regulatory treatment of asset sales to ARCs/SCs by allowing lenders to spread losses on such asset sales and permitting leveraged buy-outs for acquisition of stressed assets.

52. As the Companies Bill, 2013, has been enacted, there should be no delay in setting up the National Company Law Tribunal (NCLT) and putting in place a quick time-bound mechanism for dealing with NPAs. Further, GOI has liberalised FDI policy for the entry of Asset Reconstruction Companies (ARCs) and investment in Security Receipts of ARCs. RBI should urgently consider steps to ensure that this policy framework is implemented without any delay.

53. The new government has created expectations of boosting growth, containing inflation and increasing employment opportunities. Business sentiments have considerably improved anticipating quick and positive policy interventions. Some of the lead indicators, such as the Index of Industrial Production, car sales, Business Confidence Index, Purchase Managers' Index, buoyant stock markets and a stable rupee despite a somewhat fragile external environment are the positive signals. However a sticky inflation, possibility of a weak monsoon, higher global crude prices are some of the constraining factors.

54. Economic growth critically depends on expectations, investment and efficiency. It is necessary to have expectations buoyant. Constraints to investment would need to be tackled and efficiency in use of resources in both labour and capital which have considerable scope of improvement would need to be harnessed. Structure of economy and the proposed measures to achieve the growth potential have been indicated in that perspective.

[6] *RBI Working Paper 3/2014*

[7] *Reserve Bank of India- report on Trends and Progress of Banking in India, 2013*