Starting Up the Indian Economy

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***Abstract- The* current state of Indian economy leaves a lot to be desired with below 5% growth in GDP and the threat of high current account deficit coupled with the high fiscal deficit. The policy debate centers around the reversal of tight monetary policy by reducing the policy rate or repo rate of Reserve Bank of India (RBI) to stimulate growth and credible fiscal consolidation by reducing the fiscal deficit. The new government should focus on reviving economic growth, reducing inflation, growth of manufacturing sector and reducing revenue deficit. To stimulate economic growth India needs investment in productive physical assets, speeding up of infrastructure projects, economic reforms and last but not the least tackling the menace of corruption which paralyses the economy. All is not lost. Political will and good governance is needed from the new government.**

***Key words* - Gross Domestic Product (GDP), revenue deficit, inflation, manufacturing sector, economic growth, corruption, monetary policy**

I. Introduction

Narendra Modi took over as India's 15th Prime Minister on May 26, 2014 in culmination of an arduous election campaign that led to a stunning victory for the Bhartiya Janata Party led National Democratic Alliance. Any government that takes charge needs to make changes in policies and governance if the Indian economy has to keep its tryst with destiny. With all the election rhetoric behind us, it is action time now and expectations run sky high. The new government needs to show boldness in tackling certain issues if the Indian economy has to reach a higher trajectory of growth. Currently, the Indian economy is in a bad shape, with below 5% growth in Gross Domestic Product (GDP) and the threat of high current account deficit coupled with the high fiscal deficit.

The 'Central Statistical Organization' released the following data on 10th March, 2014

India's Real GDP Growth Rates (Factor Cost):

2010-11: 8.91%, 2011-12: 6.69% (Revised estimate), 2012-13: 4.47% (Revised Estimate), 2013-14: 4.86% (Advance Estimate)

Fiscal Indicators (% GDP):

2010-11: -4.8, 2011-12: -5.7, 2012-13: -4.9 (RE) 2013-14: (Adv.E) -4.6

Inflation:

WPI (Average) 2013-14 (Adv. E) 6.0% CPI (Average) 2013-14 (Adv. E) 9.6%

The data shows that there has been considerable slowdown in economic growth. Inflation, especially Consumer Price Inflation which hits the average consumer directly is at a higher than the threshold level and very distant from the RBI's comfort zone of 3-4%. Lower growth, stubborn inflation and the menace of twin deficits – current account and fiscal deficit are the challenges for the new government.

II. Economic Policy Issues

Currently, the policy debate centers around the reversal of tight monetary policy by reducing the policy rate or repo rate of Reserve Bank of India (RBI) to stimulate growth and credible fiscal consolidation by reducing the fiscal deficit, especially the revenue deficit, since it does not lead to creation of productive assets. It is absolutely imperative that reduction in fiscal deficit should be through increasing the tax and non-tax revenue and not through cutbacks in capital outlays as that would have a negative impact on growth. Persistence of revenue deficit arising out of excessive government consumption expenditure leads to strong demand side pressures and this has contributed to inflation. Moreover, higher reliance on domestic market borrowings by government due to higher fiscal deficit, threatened the term structure of interest rates affecting public debt management by the RBI.

Economic Policy Options

1. Reviving Economic Growth and Reducing Inflation: the linkage between monetary and fiscal policy

Good fiscal management by government would relieve the pressure from the RBI of controlling inflation that arises due to unproductive government expenditure leading to demand side pressures. This will let it focus on growth stimulating measures by reducing the repo rate thereby making borrowing for investment cheaper. This will help the Indian economy progress towards higher growth trajectory. Monetary policy and fiscal policy are inextricably linked with each other. The RBI is forced to use monetary policy for controlling inflation that arises due to government's extravagance. When it keeps the interest rates high to control inflation, growth of the economy becomes a casualty. It is very important that the new government should not curtail capital expenditure and give a big push to the economy by focusing on infrastructure development – roads, railways, ports, power generation, steel, coal, cement etc. Supply side constraints - structural bottlenecks - that lead to inflation also need to be removed.

2. Raising Agricultural productivity

The sectoral composition of India's growth story has been such that it has generated insufficient productive employment opportunities for the poor. India's structure of production is characterized by the declining importance of agriculture which would have had a positive impact in reducing poverty had it been accompanied by gains in agricultural productivity and variations in the structure of employment. Labour would have moved out of agriculture and into higher productivity sectors such as manufacturing. Raising productivity in Indian agriculture is, therefore, a key building block of a strategy for increasing incomes and inclusive growth. This requires more investments for increasing agricultural productivity and creating non-farm employment. At present, resources are channeled mostly towards providing subsidies than for productive investments in irrigation, rural roads and storage facilities.

3. Focusing on Manufacturing Sector

Simultaneously, it will be necessary to ensure that job opportunities are created in higher productivity sectors elsewhere to absorb surplus labour in agriculture. This is where another neglected area that is manufacturing, which is growing at a slow rate, needs focus from the new government. Manufacturing sector creates jobs in large numbers especially for unskilled and semi-skilled workers and job creation and income generation creates demand which leads to growth. Manufacturing output growth of 3 per cent or so in 2013-14, though much better than a negative or zero growth, is not good enough. A recent report of the McKinsey Global Institute (*From poverty to empowerment: India's imperative for jobs, growth, and effective basic services, February 2014*) observes that for making a substantial improvement in the standards of living of the Indian people and alleviating poverty, about 115 million new non-farm jobs will have to be created between 2012 and 2022 through across-the-board reforms and targeted public investment. Of these, about 27 million new jobs need to be created in manufacturing. The required growth rate in manufacturing sector output is at least 10 per cent a year. Manufacturing sector has considerable untapped potential for generating reasonably high productivity jobs. Unfortunately, Indian manufacturing has long performed below its potential. For example, the sector contributes around 15% to India's GDP, a figure that is half or less than the corresponding values for China and Thailand. Rising wages in China have created space for a new low-cost supplier and factory to the world. McKinsey and Co argues that India's manufacturing sector has the potential to create up to 90 million new jobs by 2025. Today, the sector generates only about 45 million jobs, four-fifths of which are in the informal sector. Most of the small scale ventures in informal sector are caught in a vicious circle of reliance on traditional, low-productivity technologies with limited earnings and bleak prospects for growth.

In 1962 Japanese economist Kaname Akamatsu unveiled his famous ‘Flying Geese Paradigm’. It says Asian economies will take off one by one and move in a cluster, just like migrating geese. Japan would be at the head of the formation, starting as a low-cost manufacturer of consumer goods, later making more capital-intensive items and handing over its low-end manufacturing activities to other Asian countries and that is what happened. In 1962 South Korea adopted an export-led model of growth which led to an expansion that saw the economy growing at an average of more than 8 % per year between 1962 and 1989. In 1960s Taiwan became a major exporter of labor-intensive manufacturing. Singapore's real GDP grew at an average annual rate of 8.6 % between 1965 and 1999 due to a policy of export-led growth. In 1970s Indonesia, Malaysia and Thailand joined the flying geese, with their economies developing close ties with Japan. They, too, opt for the export-led model. In 1990s a huge new economy, China, joined the group and focused on export-led growth and an emphasis on low-cost manufacturing. All these economies focused on manufacturing sector. In 2007 there came another large flying object, India. Its economy is based on domestic consumption rather than exports. It has a competitive advantage in services rather than in manufacturing. It has followed a completely new path to development, one that has not been followed by any of the late developing economies. More than half of India's GDP comes from the services sector. It is also the fastest growing segment of the economy. In sharp contrast, Asia's growth has traditionally been through low-cost manufacturing. India should use its large reserves of low-cost labour and growth in manufacturing will provide jobs in factories for the unskilled, semi skilled and skilled - all classes of people.

4. Reducing Revenue deficit

All ills of Indian economy, as explained above originated from poor fiscal management by the government. The topmost priority of fiscal consolidation is to eliminate revenue deficit within a definite time frame. This requires enhancement of revenue collection, strict expenditure control and plugging the leakages in the system. The tax-GDP ratio in India is lower currently than its levels in the past (during 2004-08) as also compared with many emerging and developing economies. The decision and allocation of investment expenditure should focus on return on investment. Reduction in fiscal deficit, along with zero revenue deficit and cost-effective investment expenditure, will help stop the crowding out of private investment. Apart from enhancing the tax -GDP ratio a reduction in revenue expenditure will also help in smoothening the pressure on aggregate demand and, in turn, will supplement the monetary measures to control inflation.

5. The menace of corruption

We all are well aware of Einstein's famous equation linking energy and mass with a mathematical constant, the speed of light: $E=mc^2$. Let us try to fit this famous equation within the context of Indian economy. There has been policy inertia in the UPA-2 government. If E in Einstein's equation is economic policy, m is monetary policy and c^2 is corruption the economic policy ($E=mc^2$) would be a mathematical function of monetary policy and the debilitating effect of corruption to the power of two. To rescue India from sub 5% GDP growth in 2013-14, economic and monetary policy will have to release its latent energy and convert it into momentum which is possible only by tackling the menace of corruption.

III. Agenda for the Government: A Recap

Revival of industrial growth in India requires a major hike in investment in infrastructure, building productive assets will boost both rural employment and new infrastructure which in turn, on completion, will generate more employment, setting off a cycle. Large scale development of industrial clusters, massive efforts towards skill formation among the youth to improve their employability, a re-invigoration of the process of economic reforms which will restore business confidence and raise industrial investments, and control of inflation are all top priority. Lower food inflation will augment the purchasing power of households and thus help improve capacity utilisation in industries.

A strong commitment to economic reforms – Liberalization, Privatization and Globalization, will bring back foreign investment, especially in infrastructure. It will boost domestic corporate investment as well. Gross fixed investment has fallen by nearly 6% of GDP, from 37% to 31%, and remains the most serious impediment to India regaining its 8%-plus GDP growth trajectory.

The Reserve Bank of India (RBI) nuances monetary policy to maintain the growth-inflation balance, the solution to high inflation and low growth – stagflation – lies squarely with the government. The ex -RBI Governor D. Subbarao rightly, identified the problem as supply-side – lack of reforms discouraging productive investment. Fiscal irresponsibility has fuelled inflation. Without fundamental economic reforms – reducing fuel subsidies, speeding up infrastructure projects and economic reforms and reducing the fiscal deficit no monetary policy instrument will put a brake on inflation or stimulate GDP growth. The next element in our reformulated version of Einsteinian equation is the impact of c^2 — corruption. This has evil consequences. It freezes decision-making. It produces bad policies. It rewards the undeserving and punishes the deserving. It destroys public trust in government. The scams that have engulfed UPA-2 have done a lot of harm to the economic growth of the nation and are an outcome of unaccountable governance. All is not lost. Economic and monetary policy can be reversed, corruption reduced. Both need political will and good governance. Let us hope the new government of this great democracy does not let down the masses and the voters who have put their trust on them.

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