

RIS is a New Delhi-based autonomous policy think-tank supported by the Government of India and devoted to trade and development issues. Its work programme focuses on policy research and capacity building on multilateral trade and financial negotiations, regional economic cooperation in Asia, South-South cooperation, new technologies and development, and strategic policy responses of developing countries to globalization, among other issues. The work of RIS is published in the form of research reports, books, discussion papers, policy briefs and journals.

RIS has networked effectively with other prominent policy think-tanks, government agencies, industry bodies and international organizations in Asia and other parts of the world for collaborative research and joint activities. It has a consultative status with UNCTAD, and has been accredited to the Summit Meetings of NAM and WTO Ministerial Conferences. It has conducted policy research and other activities in collaboration with other agencies, including UN-ESCAP, UNCTAD, UNU, Group of 77, SAARC Secretariat, Asian Development Bank (ADB), the World Bank, and the South Centre.

For more information about RIS and its work programme, please visit its website: www.ris.org.in.

— Policy research to shape the international development agenda



RIS
Research and Information System
for Developing Countries

Core IV-B, Fourth Floor, India Habitat Centre, Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-2468 2177-80, Fax: 91-11-2468 2173-74-75, Email: publication@ris.org.in
Website: <http://www.ris.org.in>, <http://www.newasiaforum.org>



On Managing Risks Facing the Indian Economy:
Towards a Better Balance between Public and Private Sectors

Ramgopal Agarwala

Discussion Paper # 158



RIS
Research and Information System
for Developing Countries

**On Managing Risks Facing the Indian
Economy: Towards a Better Balance between
Public and Private Sectors**

Ramgopal Agarwala

RIS-DP # 158

October 2009



RIS

**Research and Information System
for Developing Countries**

Core IV-B, Fourth Floor, India Habitat Centre
Lodhi Road, New Delhi – 110 003 (India)

Tel: +91-11-2468 2177/2180; Fax: +91-11-2468 2173/74

Email: publication@ris.org.in

RIS Discussion Papers intend to disseminate preliminary findings of the research carried out within the framework of institute's work programme or related research. The feedback and comments may be directed to the author(s). RIS Discussion Papers are available at www.ris.org.in

On Managing Risks Facing the Indian Economy: Towards a Better Balance between Public and Private Sectors

Ramgopal Agarwala*

Abstract: While the global economy has pulled back from the financial abyss, it is by no means out of the woods. The developing countries (including India) should be prepared for: (a) medium term stagnation in their exports to the developed countries, (b) severe reduction in inflow of longer term capital from the developed countries, (c) a high degree of instability in short term capital flows and (d) instability in exchange rates with a serious risk of a dollar crisis. The impact on the Indian economy of these external factors may be more serious than is currently recognized in official documents. The conventional approach of assessing the impact of exports on growth and of external capital inflows on investment may be flawed. A large part of the recent (2003-07) increase in saving and investment rate and in growth rate in the Indian economy may have been due to external factors. And as the external stimulus provided by rapidly growing exports and cheap external credit during these years fizzles out, so could the recent acceleration in India's GDP. In order to prevent such reversal in growth rates, increased efforts are necessary to: (a) generate domestic demand, in particular in unorganized sector where there is considerable underemployment and where additional demand can create its own additional supply, (b) mobilize domestic savings for long-term investment, (c) explore opportunities for greater South-South co-operation for trade and finance, (d) provide for protection from volatile capital flows and unstable exchange rates including a possible dollar crisis and (e) make an intensive study of financial risks of the corporate sector.

If India is to achieve a steady growth of 8-9 per cent per year over the medium and long-term, it must look for a new balance between market and state and between North and South. In business as usual scenario, India may return to pre-bubble trend growth rates of about 6 per cent per year. On the other hand with appropriate reforms (quite different from those popular under the now defunct Washington Consensus) we can turn the crisis into an opportunity for maintaining rapid growth of 8-9 per cent per year and make it more sustainable and more inclusive.

* Distinguished Fellow, RIS. Email: ramgopalagarwala@hotmail.com.
Ms. Charu Grover, Research Assistant, RIS provided research assistance.

Global Economic Outlook

It is widely agreed that the world economy is facing the greatest economic and financial crisis since the Great Depression of the 1930s. What is not so well-known is that in many aspects the pace of deterioration in recent months has been as severe as or even worse than in the early period of the Great Depression. As noted by Barry Eichengreen and Kevin H. O'Rourke in "A Tale of Two Depressions", 6 April 2009¹:

- The decline in industrial production in the last nine months has been at least as severe as in the nine months following the 1929 peak.
- While the fall in US stock market has tracked 1929, global stock markets are falling even faster now than in the Great Depression.
- World trade is falling much faster now than in 1929-30.

Thanks to the forceful actions on financial, monetary and fiscal policies taken by the world community, the panic that prevailed in the world economy in the wake of collapse of Lehman Brothers in September 2008 is largely subdued. The risks of widespread failures in banking and non-banking institutions in the US and some European countries are mitigated. Stock markets which plunged by more than 50 per cent in many countries have now recovered by 30 per cent or more. The rate of decline in industrial production, exports and unemployment in many major economies is declining. The word "depression" occurs less frequently in the google search now than a few months ago.

In its latest assessment of the world economic outlook dated 8 July 2009 IMF is presenting a slightly better outlook than in its earlier assessment in April, 2009: "global activity is forecast to contract by 1.4 per cent in 2009 and to expand by 2.5 per cent in 2010, which is 0.6 percentage point higher than envisaged in the April 2009 WEO". GDP in the advanced economies is projected to decline by 3.8 per cent in 2009 before growing by 0.6 per cent in 2010. Emerging and developing economies are projected to regain growth momentum during the second half of 2009, albeit with notable regional differences. Growth projections in emerging Asia have been revised upward to 5.5 per cent in 2009 and 7.0 per cent in 2010.

It is worth noting that the outlook on imports of developed countries (which would have important bearing on exports of developing countries) is not promising. These imports were largely stagnant in 2008 and are projected to decline by 13.6 per cent in 2009 and grow by only 0.6 per cent in 2010. Even if they grow from 2011 at the annual rate of 4.7 per cent as in 2007, it may take nearly five years before imports of advanced economies reach the level of 2008.

While presenting a slightly improved picture of growth prospects, IMF report also emphasizes the risks facing the world economy. To quote:

“The risks to the outlook are still tilted to the downside, although tail risks have diminished noticeably. In the advanced economies, rising unemployment and a loss of confidence in the stability of the financial sector (possibly resulting from a larger-than-anticipated wave of corporate bankruptcies) could put renewed downward pressure on asset prices and potentially trigger a deflationary episode. Moreover, rising questions about public debt sustainability in some countries could add to upward pressure on bond yields, with negative effects on the recovery of housing markets. Falling house prices are another important risk that could undermine confidence in bank capital bases. At the same time, a number of emerging economies remain quite vulnerable to intensified financial stress, with potential feedback effects on advanced economies. More generally, if higher unemployment and social discontent were to prompt governments to introduce trade and financial restrictions and roll back reforms to other sectors, there would be confidence and productivity would suffer. However, there are also some upside risks, including a larger-than-expected drop in risk aversion and stronger internal demand dynamics in some major emerging economies.”

The World Bank in its latest report *Global Development Finance 2009* is, however, downgrading its growth projections from its earlier assessments.

Global GDP, after falling by a record 2.9 per cent in 2009, is projected to recover by a modest 2.0 per cent in 2010 and by 3.2 per cent in 2011. Banking sector consolidation, continuing negative wealth effects, elevated unemployment rates, and risk aversion are expected to weigh on demand throughout the forecast period. Among developing countries, growth rates are higher (given stronger underlying productivity and population growth) but remain similarly subdued at 1.2, 4.4, and 5.7 per cent, respectively, over 2009 through 2011.

World Bank assessment is bearish on prospects of capital flows to developing countries.

It notes that the total private capital flows in 2008 dropped to \$707 billion (4.4 per cent of total developing-country GDP), reversing the strong upward surge that began in 2003 and reached a pinnacle of \$1.2 trillion in 2007 (8.6 per cent of GDP). For 2009, it projects a drop to \$363 billion, approximately the level of 2004 and a decline of 5 percentage points of GDP from 2007.

In his Foreword to the Report, World Bank Chief Economist Justin Lin suggests that we might be moving to an era of lower growth: To quote:

“The world is transitioning from an extended credit boom and economic overheating to an era of slower growth. Looking to medium-term developments, participants in the international financial system—consumers, investors, traders, and firms—must adapt their behavior to the new realities of tightened credit conditions, a prominent role of the state in financial affairs, large excess capacity in many industrial sectors, and more closely coordinated regulatory policy.” (p.xii)

The official projections from IMF and World Bank, though not bullish, have an understandable bias towards optimism. The prognosis coming from many private commentators is more sobering. According to some authoritative voices, the worst is not yet over in the world economy. In the

US, the epicenter of this crisis, banking and financial sector is still under stress, unemployment is still rising, real estate sector is still on the decline and consumer confidence is still weak. There are growing concerns about high fiscal deficits and quantitative easing by the monetary authorities and the risks of inflationary pressures, rise in interest rates, and loss of confidence in US dollar are high. Nuriel Roubini with a good track record in this crisis are presenting a prospect of W shaped recovery with a shallow recovery in 2010 followed by another downturn. Others talk of an L-shaped recovery with a prolonged period of slow or no growth with a recovery below the recent levels of income.

In our opinion, the US policy is still on a wrong track. Instead of accepting the need for contraction from an overextended bubble economy of 2003-07, US is trying to cure a bubble by putting more air in the system, with public profligacy (through fiscal and monetary expansion) replacing the private profligacy through imprudent credit expansion. The fiscal deficits in the US are projected to be over one trillion dollars over the next decade and the risks of reemergence of inflationary pressures and decline in value of USD are real. Perhaps it will be prudent to prepare for a prolonged recession or even a depression in the US, Western Europe and Japan over the medium term.

In the background of the above assessment, we believe that developing countries (including India) should be prepared for:

- medium term stagnation in their exports to the developed countries,
- severe reduction in inflow of longer term capital from the developed countries,
- a high degree of instability in short term capital flows and
- instability in exchange rates with a serious risk of a dollar crisis.

The question we try to address in this note is: how should India manage these risks?

Current Economic Outlook in India

The impact of the global meltdown on India has been more than earlier expected but less than that on the developed economies and some major

emerging economies. Thanks to dominant role of public sector in banking and cautious liberalization in financial sector, the banking and financial sector was not severely affected by the financial meltdown. In addition, Government of India (GOI) and Reserve bank of India (RBI) have taken measures to stimulate the economy. The latest official assessment as presented in RBI report *Macroeconomic and Monetary Developments: First Quarter Review 2009-10*, July 27, 2009 is one of mixed picture for 2009-2010: To quote:

“The growth outlook for 2009-10 needs to be assessed in the context of indications emerging from lead indicators so far. While indicators such as the higher growth in core infrastructure sector, positive growth in IIP, gradual revival in demand for non-food credit, improving performance of the corporate sector in terms of both sales and profitability, gradual return of risk appetite in the capital market, more optimistic business expectations and forecasts as reflected in the Reserve Bank’s surveys could be viewed as signs of recovery from the slowdown, there are other factors which may dampen the growth outlook such as the delayed progress of monsoon, decline in exports due to the persistence of global recession, lagged impact of the negative growth in manufacturing in the last quarter of 2008-09 on services demand, negative growth in capital goods, decline in the production of commercial vehicles, and an accelerated fall in import growth suggesting dampened demand conditions.”

The impact the global recession on the Indian economy has to be seen in the context of the fact that contrary to the general impression, the Indian economy has over the last five years become considerably outward-oriented. The ratio of trade in goods and services to GDP has increased sharply in the last few years (from 30 per cent in 2002-03 to 46 per cent in 2007-08). Exports of goods and services increased from about \$ 78 billion in FY2001 to \$314.8 billion in FY 2008. Inward flow of capital increased from \$8.5 billion in 2000-01 to \$109.2 billion in 2007-08.

How important were these increased exports and increased capital inflows for the spurt in growth in the Indian economy over the years 2003-04 to 2007-08 (8.8 per cent per years from the rate of 5.4 per cent per year in the preceding five years)? How serious are the risks of India returning to its earlier growth trajectory of 5-6 per cent per year as is implicit in the remark by the World Bank's Chief Economist quoted above?

In order to answer these questions, we need to re-examine the conventional approaches for assessing the role of external factors both on demand side and supply side.

Re-Assessing the Role of External Factors in Acceleration of Growth in India during FY2004-2008

During the period FY2004-2008, GDP growth rate in India was 8.9 per cent per year, 3.4 per centage points more than in the preceding thirteen year since 1991. This acceleration of growth in India coincided with acceleration of in growth of world output and trade during this period and availability of cheap and abundant credit in world markets as well as rapid acceleration in India's exports and capital inflows. (See Table 1). The question arises as to whether this was just a coincidence or the two were causally connected. If the former, one can argue that the acceleration of India's growth was largely due not to the external trade and capital flows but to the domestic factors and even a medium and long-term deceleration in the growth rate of world trade and reduction of capital inflows associated with the ongoing global financial crisis may not affect the medium and long-term growth trajectory of India (at 8-9 per cent per year achieved during FY 2004-8). If on the other hand, the recent acceleration in growth was largely due to external factors, the long-term reduction in growth rate of world trade and in external capital inflows may bring down the medium and long term growth rates to pre-2004 levels. In the latter case, India may have to look to domestic demand and regional trade and investment to keep up the momentum of high growth achieved in recent years.

**Table 1: Trade and Capital Inflows in India and World Economy
(Average annual growth rate, unless mentioned otherwise)**

	FY2004-8	FY1991-2003
India:		
• GDP at factor cost (1999-00 prices)	8.9	5.5
• Exports (in current \$)	25.3	9.7
• Net capital inflows	45.2	7.2 (1990-91)
(annual average in \$ billion)	109.2 (2007-08)	8.5 (2000-01)
	2003-2008	1991-2003
World economy:		
• Output	4.7	3.0
• Trade (Volume)	8.0	6.2
Developing countries:		
• Exports (volume)	11.2	7.8
• Net private capital inflows	284.7	64.1
(annual average in billion \$)		

Sources: For India: *Economic Survey 2008-09*, Government of India, 2009.

For world economy and developing countries, *World Economic Outlook*, April 2009, IMF.

The official view, as reflected, for example, in *Economic Survey 2009*, seems to be that the recent acceleration in growth was largely due to domestic factors and India should soon return to the medium-term growth trajectory of 8-9 per cent per year with continued reforms. On the demand side, it argues that:

“The most important contribution to demand growth during the Tenth Five Year Plan period (2002-07) had come from investment, while the external trade made negligible or negative contribution.” (p. 4).

On the supply side, it concludes that the step up in the trend growth rate of the India economy has come about “due to significant improvement in our domestic investment and saving rate” (p. 23). It downplays the impact of foreign capital inflows on investment rate by arguing that:

“The significant increase in the inflow of foreign capital that this period witnessed was important not so much for

bridging the domestic saving-investment gap, but for facilitating the intermediation of financial resources to meet the growing needs of the domestic industry and service sector for long term and risk capital. Moreover, though domestic funds were available, they were expensive relative to foreign funding. (p.24).

On the basis of these arguments, the *Survey* specifically rejects the view that external factors might have contributed to the recent acceleration of growth and with the slowdown in global growth and capital inflows, the India growth trajectory may also move downward. To quote:

“Following the global recession, there was a view among global market analysts, that growth in emerging markets and developing countries was driven by the global excess liquidity/monetization, the associated capital flows from developed countries and the demand for commodities. Consequently, with the bursting of the bubble the initial impact would be growth collapse followed by a return in the medium term to growth rates that prevailed before 2004-05, because of the painful process of de-leveraging and collapse of capital flows. It was therefore concluded by these analysts that India’s growth would collapse to around 4 per cent during the subsequent four to six quarters and thereafter it may revert to around 5 to 5.5 per cent over the medium term. An analysis of the growth history of India suggest that this superficial generalization of a plausible global analysis to India is erroneous.” (p. 19-20)

We argue that these conclusions need re-examination. The conventional methodology of assessing the role of external factors on demand and supply side that the *Survey* follows may be flawed and the external factors may have been more important than what is suggested by the *Survey*.

Re-examining the Conventional Approach on Demand Side

The conventional analysis uses the equation $GDP = \text{Domestic consumption}(C)$

+ Domestic investment (I) + Exports (X) – Imports (M) and estimates the role of external trade in generation of domestic income by looking at (X-M) and that of domestic demand through C+I. And since India had a negative trade balance in recent years, by this approach, the growth was due to increase in domestic demand rather exports. However, this conclusion seems somewhat surprising in view of the fact that during this period, India's exports-GDP ratio rose from 15.50 per cent in FY2003 to 20.25 per cent in FY2008 and exports particularly of services are widely seen as contributing to increased incomes in India. By this approach even for South Korea in the 1960s and 1970s when exports were rising extremely rapidly and were seen as the engine of growth, growth can be said to have been led by domestic demand. (see Table 2)

Table 2: GDP, Exports and Trade Balance, South Korea

	South Korea	
	1960-70	1970-80
GDP (annual growth rate %)	8.20	7.24
Exports (annual growth rate %)	28.52	20.54
Trade balance (% of GDP)	-10.33	-6.21
	(1960-69)	(1970-79)

Source: World Development Indicators, World Bank, 2008.

The above approach may be analytically flawed. It assumes implicitly that domestic consumption and investment are generating domestic income and all imports should be deducted from exports to get the value of domestic demand generation due to trade. Actually, however, a significant part of domestic consumption and investment may be leaking out through imports of consumer and investment goods and thus does not generate domestic income. Similarly, in order to assess the impact of exports on domestic demand generation, one should deduct from exports only those imports which enter into export products. In other words, total imports (M) should be divided into three parts: imports for consumption (M_C), imports for investment (M_I) and imports for exports (M_X) and the equation should be written as:

$$Y = (C - M_C) + (I - M_I) + (X - M_X)$$

In this equation, $X - M_X$ shows the contribution of exports to growth rather than $X - M$.

In order to assess the contribution of domestic demand and exports to growth according to the above equation, we need estimates of import content of consumption, investment and exports. These are not readily available. As a short-cut we assume that import content of exports is at most equal to the average of imports in total expenditures (C+I+X). Following this approach we find that the contribution of exports to GDP growth during 2003-2008 in India was *at least* 26 percentage points. (see Table 3)

**Table 3. Domestic Expenditures and Exports, net of Imports
(in 1999-2000 prices, Rs. ‘000 crores)**

FY	Average Import content of total expenditure (%)	Exports (net of imports)	Incremental exports net of imports	Incremental GDP	Share of incremental exports in incremental GDP (%)
2004	13.2	32.3	2.6	18.5	14.2
2005	14.6	40.4	8.1	19.9	40.6
2006	18.1	45.6	5.2	24.3	21.3
2007	20.1	53.9	8.3	27.5	30.2
2008	19.7	55.3	1.4	28.3	4.8
Total			25.6	97.7	26.2

Source: Author’s calculations based on CSO, Estimates of Gross Domestic Product for the First Quarter (April-June of 2009-2010), 31 August, 2009.

In a further refinement of the above analysis, we should allow for the fact that consumption (at least private consumption) itself would have been lower if lower exports led to lower income. If we make private consumption a function of income and solve through the above equation, we get a higher estimate of the contribution of exports to growth at about 31 per cent.

The medium term outlook on world trade is not buoyant. According to the IMF projections in the *World Economic Outlook*, April, 2009, world trade may grow only by about 2.5 per cent per year during 2009-14 as against 6.5 per cent per year during 1999-2008 and imports of developed countries by only 1.3 per cent per year as against 5.4 per cent per year earlier.

Unless India can increase its share of exports of developing countries, the growth of exports between FY2009 and FY2014 may be only 1-2 per

cent per year as against the growth rate of about 12 per cent per year during FY 2003-2008. Thus during FY 2009-14 , growth impulse coming from exports may be negligible leading to a downward pull of 2-3 per cent points of GDP compared with that in FY2003-08. Thus, unless new sources of demand can be found from internal sources and/or regional sources, GDP growth rate between FY2009-12 may settle down to about 6 per cent per year.

Re-examining the Role of External Factors in Saving and Investment

On the supply side, increase in investment rate based largely on increase in domestic saving rate during FY2004-08 can be seen as indicator of growth led by domestic factors. As noted in Table 4, during FY2003-08 foreign capital inflow defined as investment minus saving increased only marginally. If, however, we take the net external capital inflows as indicator of the role of external sector in domestic capital formation, an entirely different picture emerges. As noted in Table 4, external net capital inflows increased dramatically from 3.2 per cent of GDP in FY2004 to 10.2 per cent in FY2008. It is not clear why the net capital inflows should not be taken as indicator of the role of external factors in investment in the economy.

**Table 4. Saving and Investment
(% of GDP at current market prices)**

	2003-04	2004-05	2005-06	2006-07	2007-08
Gross domestic saving of which:	30.0	31.9	34.5	36.0	37.9
Public sector	1.1	2.2	2.4	3.4	4.5
Household sector	24.3	22.9	24.3	24.3	24.5
Private corporate sector	4.6	6.8	7.8	8.3	8.9
Gross Investment of which:	27.8	32.3	35.7	37.1	39.3
Public sector	6.4	6.9	7.6	8.0	9.1
Household sector	12.8	12.8	12.5	12.5	12.7
Private corporate sector	6.9	10.8	13.8	14.9	16.0
Memo items: (% of GDP)					
• Investment-saving gap	-2.2	0.4	1.2	1.1	1.4
• Net Capital inflow	3.2	4.5	3.3	5.6	10.2

Source: Economic Survey 2008-09.

The role of external factors becomes clearer when we examine the components of saving and investment. It is worth noting that during this period private corporate sector accounted for about 80 per cent of the increase in investment rate and about 55 per cent of the increase in saving rate. There was no increase in either saving or investment rate in the household sector which incorporates informal sector and only marginal increase in saving and investment in public sector. The sharp increase in saving and investment in private corporate sector might have more to do with external factors than is generally recognized. First, as noted in Table 4, capital inflow increased sharply during this period. As argued in *Survey*, the external inflows might have been induced by lower cost of capital from abroad than was available in the domestic market. That implies that if the cheap external funds were not available, the investment rate might have been lower. Even on savings the effect of external factor might have been significant. Improved saving performance of the corporate sector might have been connected with high profit rates earned during this period which in turn might have been connected with high export demand of the goods and services of this sector. As export growth slows down and cheap external capital dries up, both saving and investment of the private corporate sector may go down taking the national saving and investment rates down. If national investment rate goes down to the level of FY2004, a decline in GDP growth rate of 2-3 per cent point may follow.

What is presented above are only some rough calculations suggesting that the role of external factors in the sudden acceleration of growth in India during FY2004-08 (when there were no major reforms conventionally defined) might have been more than what the conventional approach claims. For a more intensive analysis, it would be desirable to construct econometric models of the Indian economy taking the external factors into account along the lines mentioned above and assess the role of external factors by simulating the performance of the economy during FY2004-08 with different levels of exports and external capital inflows. The model can then make assessment of the macro-scenarios for the future with alternative assumptions about growth of exports and external capital inflows.

Development in Q1 2010 and Outlook for the Medium Term

Developments in Q1 of FY 2010 seem to confirm the risks of a slowdown in the Indian economy. As noted in Table 5, year-on-year growth in Q1

FY2010 was only 1.7 per cent in private final consumption, 4.1 per cent in gross fixed capital formation and there was a decline of 10.9 per cent in exports. These rates of growth were considerably lower than the corresponding figures in the previous year FY2009. The overall GDP growth rate was still 6.0 per cent, largely because of an increase in government final consumption expenditures (10.2 per cent) and sharp decline in imports (-21.2 per cent), both of which may turn out to be non-recurring. Pending the results of subsequent quarters, a cautious view on the prospects of growth may be warranted.

Table 5. GDP Expenditures, FY 08-10 (at 1999-2000 prices)

	Year-on-Year growth rate (%)	
	in Q1 (April-June)	
	2008-09	2009-2010
GDP at market price		
of which:	8.3	6.0
Private final consumption	4.6	1.7
Government final consumption	0.0	10.2
Gross fixed capital formation	9.2	4.1
Exports	25.6	-10.9
Imports	26.9	-21.2

Source: CSO, Estimates of Gross Domestic Product for the First Quarter (April-June of 2009-2010), 31 August, 2009.

If the above analysis has any validity, there may be more risks to the growth trajectory of the Indian economy than what is currently recognized. The spurt in investment and growth that India experienced during 2003-2007 may have been largely a windfall resulting from the direct and indirect effects of bubble in the US economy during this period. As the bubble is deflated in the US, Indian exports and capital flows may decline to their longer term trends and so would investment and growth rates of the economy. In the absence of measures to stimulate domestic saving and investment and exports to non-OECD countries, investment rate may revert to about 30 per cent of GDP and GDP growth rate to about 6 per cent p.a.

Policy Reforms to Sustain Rapid Growth Rates

In order to prevent such reversal in growth rates, increased efforts are necessary to:

- generate domestic demand
- mobilize domestic savings for long –term investment
- explore opportunities for greater South-South co-operation for trade and finance.
- provide for protection from volatile capital flows and unstable exchange rates including a possible dollar crisis and
- make an intensive study of financial risks of the corporate sector

A brief elaboration of each of these areas of action follows.

Domestic Demand Generation and Policy Reforms

Our preliminary analysis suggest that there are ample opportunities for generating domestic demand, particularly in physical and social infrastructure and “green” expenditures to manage climate change.

The Eleventh Five Year Plan (EFYP) puts a figure of \$502.8 billion (at 2006-07 prices) for investment in physical infrastructure during the period 2007-12. This will mean a rise in infrastructure investment from about 5 per cent in 2006-07 to 9.0 per cent in 2010-2011. Eleventh Plan puts emphasis on private sector’s role² in financing infrastructure in PPP mode, with private sector providing 30 per cent of investment. It also expects 48 per cent of this investment to be financed from debt resources, of which 12 per cent is expected from external commercial borrowing.

The above assumptions of EFYP need to be revisited in the current context of global financial crisis. Both reliance on private sector and that on external commercial borrowing may have to be revised downward. Although no firm figures on investment in infrastructure for FY2008 or 2009 are available, investment in infrastructure, in particular that by the private sector, is falling short of Plan expectations. Credit to the private sector, both domestic and foreign, is facing tight squeeze and that may continue for some time. It would be unrealistic to assume that the Eleventh Plan targets on physical infrastructure can be met without additional public investment. And so far as external sources are concerned, greater resort to public funding may be

essential to meet the targets. We may be moving back to the earlier period where public investment and multilateral agencies were the main sources of funding infrastructure.

In the remaining three years of the Plan (2009-12), infrastructure investments were expected to be about 8.3 per cent of GDP. However on business as usual scenario, this ratio cannot be expected to be more than 6 per cent. Thus there is a gap of at least 2 per cent of GDP or about \$70 billion to be filled in the next three years just for meeting the infrastructure investment targets of EFYP.

For management of climate change the Indian policy paper, *National Action Plan on Climate Change (NAPCC)*, has put forth a programme of eight “missions” relating to solar energy, energy efficiency, sustainable habitat, water, sustaining Himalayan ecosystem, “green India”, sustainable agriculture and strategic knowledge for climate change. There is no estimate in NAPCC of the level of expenditures needed for funding these missions. However, if we use the global figures on resources needed for managing climate change, (about 1 per cent of GDP), these missions in India can be expected to absorb at least \$10 billion per year. Now is the time for implementing these programmes effectively and mobilize necessary resources, some of which may come from regional funding agencies.

In the social sector, poor performance of India is well known. Among others, Amartya Sen has been tirelessly highlighting the serious deficiency in provision of basic social services in India. EFYP aims at increasing the expenditures (as per cent of GDP) in social sector (defined as including education, health, nutrition water and sanitation) to about 8 per cent of GDP. However, as of 2008-09, this ratio seems to be falling short of the targets by at least 1 per cent of GDP. The need for economic stimulus is a good occasion to increase allocation of public expenditures in this sector and to identify efforts to improve implementation.

Taking the need for physical and social infrastructure and green expenditures, additional domestic expenditures of about 4 per cent of GDP

or about \$50 billion per year for the next three years may be entirely appropriate in the current conditions. A large part of this stimulus may be directed to the so-called informal sector (which accounts for as much as 90 per cent of the employment and constitutes “the bottom billion” in the country) where there is a large degree of underemployment and where supply elasticity to increased demand may be high. Focusing on how to increase incomes of the bottom billion is desirable not only from a social point of view but is also an economic imperative to maintain high growth rates over the medium-term.

Resource Mobilization

Over the medium-term, inflow of external private capital is likely to decline and alternative sources of funding needs to be identified to meet India’s investment needs.

Three lines of action are suggested:

- First, a more determined effort should be made to generate government savings through reduction in subsidies and unproductive expenditure.
- Second, pension schemes should be invigorated to mobilize long term savings.
- Third, greater efforts should be made to augment lending resources of global and regional Multilateral Development Banks (MDBs).

In addition, India should join in efforts to design a new structure of regional financial co-operation so that the region’s excess foreign exchange reserves can be utilized to generate long-term funding for regional investments.³

Greater South South Co-operation in Trade and Finance

As the capacity of imports of the North declines, India has to find markets in Asia and the rest of the South. India’s “Look East Policy” has been in operation for some time. But the progress in trade and financial sector integration has been below the needs. In RIS we have been arguing for some time that we need to make a breakthrough in Asian institutions for promoting trade and financial co-operation. However, these proposals have not yet received much traction at official level. We believe that time has come to study these and other proposals for regional integration more seriously.

Risks of Volatile Hot Money Flows

As the risk aversion in the international markets is diminishing, there is a risk of increase in hot money flows to India. With interest rates low in the US and the risk of dollar depreciation, investors may well show increased interest in investing in Indian stocks and bonds. These hot money flows may lead to pressures for exchange rate appreciation and reserve accumulation beyond India's needs. The rate of return earned on foreign exchange reserves may be lower than the payment made to external agents of the hot money flows. We should give up the concept that more of capital flows and more of forex reserves are always better. We need to conduct a thorough cost-benefit analysis of capital flows under FIIs, ADRs/GDRs, etc. Perhaps we need to define a concept of absorptive capacity for hot money flows and have a system of taxation of short-term flows as has been practiced by Chile among others and recommended by economists such as Tobin.

Risks of Exchange Rate Instability and Dollar Crisis

In preparation for a possible dollar crisis, India should explore opportunities for diversifying the currency composition of its trade and reserve systems. It should also institute measures for greater stability in its exchange rate movements. A special committee may be appointed to review the current policies on management on forex reserves, management of exchange rate and capital inflows.

Risks Facing the Corporate Sector

As World Bank's *Global Development Finance 2009* notes the current crisis has been triggered not so much by imprudence of the public sector but by that of the private corporate sector. To quote:

“Unlike most crises over the past three decades, the impact of the current crisis on developing countries has been transmitted primarily through the corporate sector. As firms' reliance on short-term debt has increased, so has the probability of default, particularly in highly leveraged firms. As refunding pressures are building, sources of finance are drying up. Many private firms will be hard pressed to service their foreign-currency liabilities with revenues earned in sharply devalued domestic currencies.”

The report notes that before the crisis, between 2003 and 2007, firms based in emerging markets raised \$1.2 trillion in external debt via syndicated bank deals and bond issues, in order to grow and build their global presence through trade investment and cross-border M&A. The foreign debt contracted by developing country corporations in South Asia (of which India probably had a lion's share) rose from an annual average of \$2.9 billion during 1998-2002 to \$15.7 billion during 2003-07 (with a figure of \$35.9 billion in 2007). Many developing-country firms participated in the global expansion of derivatives. In India, for example, the stock market boom was accompanied by futures trading that was at least six times the turnover in spot. "Carry trades" were a common speculative vehicle, with an estimated volume of between \$200 billion and \$1 trillion in recent years.

As argued above, during the last few years Indian corporate sector has increased investment sharply, much on it on borrowed funds, and that mostly from abroad. As external and internal demand slows down, corporate sector may face a decline in profits. And combined with decline in availability of external capital, the sector may face some serious problems of liquidity and/or solvency. There may be serious currency and term mismatches in the borrowings and investments of corporate sector and there may be risks to the Indian economy reminiscent of what happened to the Korean economy in 1997-98.

It is, therefore, necessary to conduct a detailed analysis of the risks facing the corporate sector of the Indian economy and their possible impact on the Indian economy, including the financial sector.

Reserve Bank of India released in March 2009 its report of assessment of financial sector entitled *India's Financial Sector: An Assessment*. Its conclusion was that:

"Overall, the assessment has found that the financial system is essentially sound and resilient, and that systemic stability is robust." It carried out single-factor stress-tests for credit and market risks and liquidity ratio and scenario analysis which showed no significant vulnerabilities in the banking

system. However, it found a serious gap in the area of timely implementation of bankruptcy proceedings with the average time taken in India for winding up proceedings one of the highest in the world. It concluded that “a quick resolution of stressed assets of financial intermediaries is essential for the efficient functioning of credit and financial markets.”

The issue of bankruptcies in the corporate sector may acquire greater salience as the global financial crisis unfolds. The newspaper stories of financial stress in the airlines industry in India (whether in public sector such as Air India or private sector such as Kingfisher Airlines) may be symptomatic of the risks facing the corporate sector in India. IMF is in its recent report entitled *India: Selected Issues*, June 2009 examines the issue of vulnerability of the corporate sector and its possible impact on the Indian economy. It comes to the following sobering conclusion:

“Our analysis suggests that the ongoing global crisis could have a serious impact on the Indian corporate sector and near-term growth. The significant volatility in the exchange rate, equity prices, and interest rates triggered by the global crisis, together with the decline in global economic activity and capital flows will weigh on India’s firms. For a reasonable set of shocks (which have largely already happened) the number of firms facing problems in servicing their debt obligations could more than double. Despite fairly strong corporate sector balance sheets as of March 2008, lower equity prices and increased equity market volatility imply a much lower buffer against distress. The estimated economic growth impact could be over four percentage points; with GDP growth rate in 2007/08 at 9 per cent, these estimates imply a deceleration to around 5 per cent.” (p.6)

The IMF analysis is based on firm-level data relating to year 2007-08 provided by the Centre for Monitoring the Indian Economy (CMIE). A more

in-depth stress test analysis should perhaps be done by Ministry of Corporate Affairs, Government of India by using more recent data and careful evaluation of the quality of data. The statistical analysis should be supplemented by in-depth interviews with people familiar with the inside story of the corporate sector and in close interaction with RBI study team on Financial Sector Assessment.

Conclusion

It is increasingly clear that the current financial and economic crisis may well be a watershed event in world economic history. The center gravity of the world economy is moving from the North to the South. The economic management paradigm represented by Washington Consensus is in stress and search is on for a new paradigm based on partnership between public and private sector. If India is to achieve a steady growth of 8-9 per cent per year over the medium and long-term, it must look for a new balance between market and state and between North and South. In business as usual scenario, India may return to pre-bubble trend growth rates of about 6 per cent per year. On the other hand with appropriate reforms (quite different from those popular under the now defunct Washington Consensus) we can turn the crisis into an opportunity for maintaining rapid growth of 8-9 per cent per year and making it more sustainable and more inclusive.

Endnotes

- ¹ See <http://economistonline.blogspot.com/2009/04/eichengreen-tale-of-two-depressions.html>
- ² EFYP was designed to rely “as much as possible” on private sector investment in infrastructure through various forms of PPPs, though it also noted “it must be recognized that it will not be easy to bring in private investment at the scale required”.
- ³ See, for example, *RIS Discussion Paper # 133*, “Towards An Asian “Bretton Woods” for Restructuring of the Regional Financial Architecture” by Ramgopal Agarwala.

RIS DISCUSSION PAPERS

Available at http://www.ris.org.in/risdiscussion_papers.html

- DP#154-2009 *Trade Facilitation, Information Technology and SMEs: Emerging Evidences from India* by Sachin Chaturvedi
- DP#153-2009 *Climate Change, Technology Transfer and Intellectual Property Rights* by K. Ravi Srinivas
- DP#152-2009 *The Limited Promise of Agricultural Trade Liberalization* by Timothy A. Wise
- DP#151-2009 *Who Uses the Patent System in Developing Countries? A Study of Patent Propensities in Argentina, 1992-2001* by Andrés López and Eugenia Orlicki
- DP#150-2009 *Policies for Industrial Learning in China and Mexico* by Kevin P. Gallagher and M. Shafaeddin
- DP#149-2009 *Eradicating Poverty in India: Lessons from Experiments in Empowerment* by Beena Pandey
- DP#148-2009 *India's Outward Foreign Direct Investments in Steel Industry in a Chinese Comparative Perspective* by Nagesh Kumar and Alka Chadha
- DP#147-2009 *India's Role in East Asia: Lessons from Cultural and Historical Linkages* by Ellen L. Frost
- DP#146-2008 *Livestock Industrialization, Trade and Social-Health-Environment Impacts in Developing Countries : A Case of Indian Poultry Sector* by Rajesh Mehta, Clare A. Narrod and Marites M. Tiongco
- DP#145-2008 *South-South and Triangular Cooperation in Asia-Pacific: Towards a New Paradigm in Development Cooperation* by Nagesh Kumar
- DP#144-2008 *Exchange Rate Pass-through in India's Exports to Developed and Emerging Markets* by Sushanta Mallick and Helena Marques
- DP#143-2008 *Changing Economic Power* by Manmohan Agarwal
- DP#142-2008 *Transportation Cost and Trade Competitiveness: Empirical Evidence from India* by Prabir De and Bhisma Rout
- DP#141-2008 *Re-Discovering the Role of Developing Countries in the GATT before the Doha Round* by Faizel Ismail

- DP#140-2008 *Internationalization of Indian Enterprises: Patterns, Strategies, Ownership Advantages and Implications* by Nagesh Kumar
- DP#139-2008 *Emerging Patterns in Architecture for Management of Economic Assistance and Development Cooperation: Implications and Challenges for India* by Sachin Chaturvedi
- DP#138-2008 *Rise of BICS and the World Economy Implications of India's Recent Expansion on Developing Countries* by S.K. Mohanty
- DP#137-2008 *Emerging Countries as Sources of Investment and Appropriate Technology: Case Study of India* by Sachin Chaturvedi
- DP#136-2008 *Potential of Asian Economic Integration: A Perspective from the Strategy of Japanese Enterprises* by Tetsuji Kawamura
- DP#135-2008 *East Asian Infrastructure Development in a Comparative Global Perspective: An Analysis of RIS Infrastructure Index* by Nagesh Kumar and Prabir De
- DP#134-2008 *India-Africa Economic Partnership: Trends and Prospects* by S. K. Mohanty and Sachin Chaturvedi
- DP#133-2008 *Towards An Asian "Bretton Woods" for Restructuring of the Regional Financial Architecture* by Ramgopal Agarwala
- DP#132-2008 *The WTO's Doha Negotiations: An Assessment* by Bhagirath Lal Das
- DP#131-2007 *Regional Cooperation and Integration Prospects in Asia* by Rajat Nag
- DP#130-2007 *Deepening India-Bangladesh Economic Cooperation: Challenges and Opportunities* by Prabir De and Biswa N. Bhattacharyay
- DP#129-2007 *Intellectual Property Regime, Indigenous Knowledge System and Access and Benefit Sharing: Drawing Lessons from Kani Case* by Sachin Chaturvedi
- DP#128-2007 *WTO and Trade in Electronically Delivered Software (EDS): Emerging Challenges and Policy Options - An Indian Perspective* by Sachin Chaturvedi and S. K. Mohanty
- DP#127-2007 *Economy: Recent Evolution and New Perspectives for South-South Cooperation* by Maria Lúcia L.M. Pádua Lima
- DP#126-2007 *Welfare Gains from Regional Economic Integration in Asia: ASEAN+3 or EAS* by S.K. Mohanty and Sanjib Pohit