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Sebastian Morris

Macroeconomic Policy in India Since the Global Financial Crisis

Trends, Policies and Challenges in Economic Revival Post-Covid

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This book is dedicated to the memory of my mother Imelda Morris, who lived completely selflessly for her children.

Preface

The belief that India is the fastest growing economy is widely held, and the government in recent years has made this claim repeatedly. After 2015 China slowed down, and India's growth was in the same range as China's. The comparison, if truly driven by a keen desire to make the economic transition, as it should be, would have to be with the East Asian Tigers and China, during their transformation phases. Korea and Taiwan grew at around 8% over more than three decades, with brief interruptions caused by global shocks (most notably the Oil shock, during the late 70s). They were able to lift themselves well above the "middle-income levels" to reach nearly advanced country status. Singapore went on to become one of the richest countries in the world on its own steam with no natural endowments. While the case of Singapore could perhaps be kept aside due to its small size and city status, the cases of Korea and Taiwan are most relevant. From 1979 till almost 2014, China has grown at rates above 9% to take the economy to within striking range of being an advanced country.

Yet, these economies hardly find mention among the policymakers and academics in India. The facts of their growth experience are readily pooh-poohed by the Indian intelligentsia, even by the few among them, who are concerned about growth and the economic transition. Others, who worry about the human agency, are predisposed to ignore growth. They create a false hiatus between growth and (human) development. The evidence is overwhelming that no country of any substantial size has made sustainable human development without economic development. Though the two are not exactly parallel, their trajectories tend to be in step. Deviations are almost entirely explainable in terms of the distribution of income, which in turn may have been caused by social and economic factors.

For many others, the economic transition does not seem to matter. It is some archaic notions of identity and culture that they seem to be concerned about. Modernization (with the inclusion that goes with it) appears alien and intrusive to them. Unfortunately, this segment of the intelligentsia has grown in recent years. Limited growth, in not being able to include all, but having benefitted the middle classes substantially, may have contributed to the rise of this segment. The political discourse today reveals that Indian society is at an inflection point where the middle classes as

a whole are beginning to show their impatience with the inclusive democracy that is India, and take more than potshots at it. The failure to provide public services is at the root of this impatience, slowness of growth has limited inclusion. Elites who believe in modernization and democracy underestimate the dangers of not having high enough growth, and in leaving the problem of public services delivery unaddressed.

The so-called "middle-income" barrier has entrapped many nations, and the few instances of escape are almost exclusively the export-led (high) growth economies. Additionally, our poor land endowments per person, similar to Korea, Taiwan, and Japan, make these cases relevant. Would India be able to follow these economies? If it does not, risks to its unity would arise, belying the great political program of an inclusive society that was initiated with independence. When the cake grows slowly, the concern about where the cuts are made takes precedence over growth. The slowness of economic growth in India casts doubt on whether it is on its way to its economic transition. We know that the later a country has successfully transited, the quicker its transition has been.

Social media is rife with the country's achievements both real and fictional. The reality that India houses some 30–40% of the world's misery be it disease, poverty, unemployment, hurt due to pollution, child undernourishment, or illiteracy stares starkly at anyone who chooses to make even a casual glance at the reality. Countries with vastly superior endowment of natural resources—many of them African, Central Asian, and Latin American—can at least reach the middle-income level riding on the dynamism of the advanced countries and China. India has no option but to create its own high-speed engine of growth. The Philippines' approach of depending largely on remittances is out for India. It is just too big. That approach cannot, even for the Philippines, ensure the economic transition. The thin original middle class of India that exported much of the younger generation out to escape to a better life cannot be the model for the billion that waits.

We overcame hunger through the high growth that raised the poor's incomes, aided by the MGNREGS. But over the last 9 years or so growth had been slow. The COVID crisis has been particularly harsh on the poor and many millions have lost their jobs. Now, with almost 2 years into the crisis and recovery, the GDP has just crossed the pre-COVID level, and the effective employment is much below the pre-COVID levels. The years before the COVID were also nearly stagnant on employment. It is no longer possible to explain (away) the slowdown by pointing to the external conditions and shocks. While these are important, the small size of the economy, yet relative to the world economy means that it is action and policy within that would determine the course of the economy.

It is on this matter of growth that we focus. The framework of analysis is essentially macroeconomic with the demand determined level of output being central. The structure of the economy, with the impact of policy and action on the structure, in influencing the capacity to produce, is also important. But we do not cover all aspects of the same. We know that demand and the capacity to produce (the emerging economy equivalent of the full employment level of output in the mature economies) have to rise keeping in step. Reform for the better can be held back if

demand is not in sync. Excessive demand, without the reforms to extend and improve capacity, can only be ephemeral and inflationary.

The fact that India has vast surplus labor would mean, at an abstract level, that over the longer term, there is only one real constraint that policymakers need to accept—land. Capital and hence the capacity to produce is only a current "constraint" that can be overcome with investment—an objective of macroeconomic policy. And much (though not all) of technology can conceivably be "imported". And even technological development is actionable by policies that attempt to counteract the market failure in its generation. Skill development is part of the process of reform and structural change. In other words, growth is the best recipe to overcome constraints, even as policies—industrial, trade, and tax—besides governance and administrative reform that address constraints make room for growth.

Hence, the fact that India is not growing at high rates is a matter of much concern. There is little comfort in it growing at anything less than 7%. We believe that with the potentially great dynamism of the private sector, policymakers would have to work hard to give it less than 5%! Yet, there seems to be an acceptance of low growth by many in positions of power and influence. The RBI in giving itself "inflation targeting" may have veered away from a concern for growth. Understandably, growth cannot be achieved by monetary policy alone. But in an emerging economy context (with the existence of idle labor), the mantle of growth cannot be shirked away by appealing to doctrinaire notions that may have been functional in the developed country context of labor tightness. The current fashion should not be acceptable on its currency alone. Left leaners also cannot neglect high growth. In a market economy, when the technology itself (as capital intensity expands) can give an aggregate labor productivity of nearly 5%, growth at any less rate cannot lead to labor absorption. This does not mean that the march of innovations and capital investments be restrained, or that work norms be lowered. That would amount to backpedaling. At 9% growth, there would be labor absorption at about 4%. And that when sustained over a couple of decades would undoubtedly ensure the economic transition. The demographic dividend is not automatic, unlike what many populists believe it to be. It can only be achieved with high growth, and the "asking" rate for its achievement only increases with the backlog of idle labor that slow growth engenders.

Today, it is a little less difficult to argue against orthodoxy that "governments and the central banks have a role merely in inflation control". The Global Financial Crisis (GFC) has shaken the foundations of the sterile and unreal world of rational expectations equilibrium schools. Their tenets of policy irrelevance and equilibrium of markets and the economy as a whole, which vice-like held their reign over the academic macroeconomics, are fading away. Similarly, the aspect of coordination between central banks and the government on macroeconomic matters cannot be easily dismissed. In the case of emerging economies much more is required from the visible hand. The aspect of strategic macroeconomic policy that recognizes as its objective, the use of idle labor to export to the rich countries and more generally, needs recognition. The macroeconomic dimensions of export-led growth constructed from the stories of China (until today), Taiwan and Korea (till about 1997), and Japan much earlier need to be brought to the forefront in policymaking in India.

No country of any substantial size has made the economic transition without a prior or simultaneous agricultural transformation. Today India may well be at that point when the terms of trade need to rise in favor of agriculture. Only then can agriculturists' incomes rise to slow the divergence between rural and urban incomes. Otherwise, inclusion would be hurt, and the home market would constrain. China, with its somewhat higher level of income (and far more egalitarian distribution), reached this stage almost immediately after its open-door policy. Despite the growth of agriculture at 6% or so since then for 8 years or so, inflation largely on account of food prices was high given the small but sustained gap between demand and supply. Chinese policymakers' understood the structural context and the supply-side aspect, and did not respond to this inflation to curtail demand through macroeconomic particularly monetary measures. The inflation over a decade and a half passed over as the food demand growth slowed down. Today we see the RBI targeting inflation—not just the core—and being ever ready to tighten as if that could bring down food demand—the most basic of all demand which for most (other than the very poor bottom 40%) would be income inelastic. Not only does it arrest inclusion but also retards growth with no gain in terms of reduced inflation. The fact that high growth has made nearly all—even the urban poor—calorie "sufficient" c. 2015 should have given the RBI greater confidence to pursue growth, recognizing the structural necessity of including the agriculturists in the home market demand. Of course, supply-side initiatives, including measures that improve the farmers' take from the consumers' expenditure on food, are important, but that gets into strategies for agricultural transformation and falls outside the scope of this book.

Analyses of the macroeconomy cannot anymore relegate the financial sector to the background. The quantum of financial assets in portfolios has gone up much faster than either assets or GDP. This has been a global phenomenon, and while the advanced countries have taken the lead, the emerging economies too show large rises in financial asset holding. Low costs of financial transactions, heightened information availability (though not of valuation), and participation through algorithms have meant the development of leverage and more frequent determination of market prices. The concomitant demand for liquidity arising out of portfolio demand relative to the transactions demand has been rising sharply. Similarly, exchange rates over the short run are almost entirely determined by capital flows, even though the current account would have a role in driving expectations. Hence, the gamut of monetary policy has expanded to include besides liquidity (and/or low-end rates) to actions along the yield curve, to direct support of private entities (quantitative easing), besides of course the foreign exchange markets.

Executives and administrators rightly think in terms of action, and the sharp distinction between policy and other actions is not clear in their minds. However, for governments and central banks, it is important to think in terms of policy and underplay action/intervention of a direct kind, or indulge in advice. Notably, the government in India goads the industry to process more food, while the tax policy is completely orthogonal to that objective. RBI desires a high level of transmission by banks, but its own policies and stances could drive banks to poor transmission. As the economy matures it is important to move away from action and discretion,

to working through policies. It has become fashionable among the many in the intelligentsia to blame all our failures on the politician. Some go to the extent of creating the "political class" on whom if the problem can be ascribed, so no more analysis is required. We would think this is self-defeating. Most of the problems of the country are correctible through a change in policy, law, framework, organization, design, etc., and the academic has the role to discover the specific leverage points for change in society. Crisis present opportunities for change, but more often than not the constructive answers for change are not ready with policymakers. The few instances when they were—as during the balance of payments crisis of 1991–1992, the Great Liberalization followed, to deliver the economy out of the mess of the previous decade.

This book takes a detailed look at the growth experience of India since the GFC. It has to take a detour into the measurement issues given the significant divergence in growth as computed from the older 2004–2005 GDP series and the new 2011–2012 series. Many more series than what is used in conventional analysis had to be considered to build a consistent picture.

The period covered includes the terms of the UPA-II, Modi-I, and Modi-II which is on today. The regime changes have been sharp. Not only the executive, but the judiciary through its actions had amplified uncertainties on the economy. While I don't cover the high growth period that preceded the GFC nor the GFC itself, references to the same, are inevitable in any discussion. The presentation and the approach of the analysis majorly work on the determinants of demand and of inflation whether these arise from external shocks or internal actions including policy with a focus on the fiscal and the monetary. The discussion is on "high growth". Why did it elude India after having had two rounds of high growth? References to the East Asian Tigers cannot be avoided, though this is hardly a comparative study.

It is almost a truism that India has to find ways of engaging its vast "idle" population. And to do that demand for manufactured goods and tradable services—through exports and home market demand—has to grow rapidly. Investment ratio, employment growth, and export growth, therefore, become the true indicators of performance. A brief consideration of manufacturing performance, although not strictly within the domain of macroeconomic analysis, is also included.

So also, the GST being destination-based would create fiscal disincentives for production-oriented regions in their support of investments, a role that regional governments ought to keenly play at the current phase of development of the economy. The Goods and Services Tax (reform) becasue it integrates the home market and removes distortions is vital. Should there not be compensatory mechanisms for the production states?

Over time, I hope very much that the perspectives developed here would help in framing the issues in macroeconomic management after the more detailed analyses are contested and debated.

Ahmedabad, India Sebastian Morris

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Abbreviations

AFC	Asian Financial Crisis
AIC	Akaike Information Criteria
AIEI	Association of Indian Engineering Industry (now absorbed into the CII)
APMC	Agriculture Produce Marketing Committee
BEL	Bharat Electronics Ltd
BFSI	Banking, Financial Services and Insurance (companies)
BHEL	Bharat Heavy Electricals Ltd.
BHEL	Bharat Heavy Electricals Ltd.
BICP	Bureau of Industrial Costs and Prices (now includes the Tariff Commission)
BIMARU	(The Indian States of) Bihar, Madhya Pradesh, Rajasthan, and UP
BJP	Bharatiya Janata Party
BSE	Bombay Stock Exchange
CAG	Comptroller and Auditor General of India
CBDT	Central Board of Direct Taxes
CBM	Coal Bed Methane
CENVAT	Central Value Added Tax (of the Centre before GST)
CII	Confederation of Indian Industry
CLSS	Credit Linked Subsidy Scheme (of GOI)
CMIE	Centre for Monitoring the Economy
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
CSO	Central Statistical Organization
CSR	Corporate Social Responsibility
DBT	Direct Benefit Transfers
DEITY	Department of Electronics and Information Technology (now MEITY)
DIPP	Department of Industrial Policy and Promotion (now DPITT)
DISCOM	Distribution Companies (in the electricity business)
DPITT	Department of Industry and Internal Trade

DSGE	Dynamic Stochastic General Equilibrium
ECIL	Electronics Corporation of India Ltd.
ELG	Export-Led Growth
EO, CMIE	Economic Outlook (database of the CMIE)
EPR	Effective Protection Rate
FBs	Foreign Banks
FCI	Food Corporation of India
FDI	Foreign Direct Investment
FII	Foreign Institutional Investment
FMCG	Fast moving consumer goods
FPI	Foreign Portfolio Investment
FSI	Floor Space Index
FSSAI	Food Safety and Standards Authority of India
GCF	Gross Capital Formation
GDP04–05	The older GDP series with 04–05 as base year
GFC	Global Financial Crisis
GL	The "Great Liberalization" of 1991–1992 and 1992–1993
GOI	Government of India
GQ	Golden Quadrilateral
GST	Goods and Services Tax
GSTIN	GST network
GVA	Gross Value Added
GVA11–12	The new series with of National Income with 11–12 as base
H	High powered money
H	High Powered Money
HCL	(earlier) Hindustan Computers Ltd. (now HCL)
HRA	House Rent Allowance for Government and Public Sector workers
IAS	Indian Administrative Service
ICOR	Incremental Capital Output Ratio
IDFC	Infrastructure Development and Finance Company
IESA	India Electronics and Semiconductor Association
IIP	Index of Industrial Production
ILFS	Infrastructure Leasing and Financial Services
ITA	Information Technology Agreement
ITES	Information Technology Enabled Services
ITS	Indian Trade Service
LA	Latin America
LFPR	Labor Force Participation Rate
M0	Base Money
M1	Narrow Money
M3	Broad Money
MCLR	Marginal Cost Based Lending Rate
MCLR	Marginal Costs (of funds based) Lending Rate
MEITY	Ministry of Electronics and Information Technology
MFA	Multi-fiber Agreement

MGNREGS	Mahatma Gandhi National Rural Employment Guarantee Scheme
MIO	Market Intervention Operations
MODVAT	Modified Value Added Tax
MRO	Maintenance, repair and overhaul (of aircraft)
MSF	Marginal Standing Facility
MSME	Micro Small and Medium Enterprise
MSPs	Minimum Support Prices
NAC	Non-agricultural Clearance
NAIRU	Non-accelerated Inflation Rate of Unemployment
NAS	National Accounts System
NBFCs	Non-banking Financial Institutions
NCD	Non-Convertible Debentures
NCLAT	National Company Law Appellate Tribunal
NDA	National Democratic Alliance
NDDB	National Dairy Development Board
NEC	(earlier) Nippon Electric Corporation (now NEC)
NELCO	National Electronics Company
NHAI	National Highway Authority of India
NHDP	National Highway Development Programs
NMDC	New Delhi Municipal Corporation
NPAs	Non-performing Assets (of banks)
NSE	National Stock Exchange
NSSO	National Sample Survey Organization
OMO	Open Market Operations
PBDIT	Profit before depreciation interest and tax
PES	Periodic Employment Survey
PFC	Power Finance Corporation
PFCE	Private Final Consumption Expenditure
PLI	Production Linked Incentive (Scheme)
PLR	Prime Lending Rate
PMEAC	Prime Minister's Economic Advisory Council
PMGSY	Prime Minister's Gram Sadak Program (Village Road Program)
PMMSY	Prime Minister's Matsya Sampada Yojyana
PMO	Prime Minister's Office
POL	Petroleum, Oil and Lubricants
PSBs	Public Sector Banks
PSFIs	Public Sector Banks and Financial Institutions
PSU	Public Sector Undertakings
PSU	Public Sector Undertaking
PVSBs	Private Sector Banks
RBI	Reserve Bank of India
REC	Rural Electrification Corporation
REE	Rational Expectations Equilibrium
REER	Real effective exchange rates
RERA	Real Estate Regulatory Authority

RNR	Revenue Neutral Rate RNRS: Revenue Neutral Rate for a State
RRCA	Relative Revealed Comparative Advantage
SBI	State Bank of India
SLR	Statutory Liquidity Ratio
TB	Treasury bills
TLTRO	Targeted Long-Term Repo Operations (of the RBI)
UPA	United Progressive Alliance (led by the Congress Party)
VAT	Value Added Tax (of States before GST)
VGF	Viability Gap Funding
WPI	Wholesale Price Index
WTO	World Trade Organization

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