Rethinking Macroeconomic Policy in India

(Edited Papers)

Editors

Dr. Roy Scaria

Tojo Jose

Dr. B. Pradeepkumar

PRAKASH PUBLICATIONS

Changanacherry

Rethinking Macroeconomic Policy in India
(Edited Papers)
English Language

Editors
Dr. Roy Scaria
Tojo Jose
Dr. B. Pradeepkumar

Printed & Published by
Prakash Publications & Printers
Changanacherry

Type setting
Pullukadan DTP Centre
Changanacherry

First Edition: December 2014

ISBN: 978–93–81888–73–5

Price : ₹ 150/-

PREFACE

Now the world economy is going through a 'great recession' which is unparallel in history since 1930s. During the last three decades, economic activities in most economies have been characterised with continuously declining variability of output gap and inflation which is well described as the 'great moderation'. This has been believed to be the result of attaining a coherent macroeconomic condition mainly supported with 'financialism', but proved false.

Banks are found to be forgetting structural factors while designing monetary policy and remains failed black magicians than sophisticated policy designers. Monetary policy has been pursing with a single objective, price stability. The RBI is not an exception as it tries to move in these lines. While barking on inflation, it bites the economy with relatively high inflation and slow growth rates in real sectors. Hence, the current monetary policy lost its credibility.

Nowadays, due to lack of precision, overdoses and lags, fiscal policy has been misplaced to the back seat behind the monetary policy. Policy makers are perplexed with the crisis on how to use and the specific package of fiscal policy to be applied. Thus, time has reached for us to make a rethinking of the current macroeconomic policies across the globe in general and India in particular.

The crisis, as happened in other economies, had permeated to India through all channels and it prompted the academia in India too to initiate debate on the macro policies here. This book is a collection of edited research papers, on the 'Rethinking Macroeconomic Policy in India' authored by people from economics academia.

December 11, 2014 *Editors*

CONTRIBUTORS

1. Dr. Roy Scaria, Assistant Professor, Department of Economics, TM Jacob Memorial Government College, Manimalakunnu, Koothattukulam, Kerala.
2. Prof. Dr. G. Visakh Varma, Former Principal, KKTM Colle Pullut, Kerala.
3. Dr. S.R Keshava, Professor, Postgraduate Department of Economics, Bangalore University, Bangalore-560056
4. Santhosh T Varghese, Assistant Professor, Research Department of Economics, Maharajás College, Ernakulam, Kerala.
5. Dr. B Pradeepkumar, Assistant Professor of Economics, Government College, Ambalappuzha, Kerala.
6. Tojo Jose, Assistant Professor, Department of Economics, TM Jacob Memorial Government College, Manimalakunnu, Koothattukulam, Kerala.
7. Dr. M.P Abraham, Assistant Professor, Postgraduate Department of Economics, University College, Thiruvananthapuram, Kerala.
8. Shijo Philip, Assistant Professor, Postgraduate Department of Economics, University College, Thiruvananthapuram, Kerala.
9. Dr. M.V Suresh, Associate Professor and Head, Postgraduate Department of Economics, NSS Hindu College Changanaserry, Kerala.
10. Anjali Prakash, Assistant Professor, TM Jacob Memorial Government College, Manimalakunnu, Koothattukulam, Kerala.
11. Anilkumar. P, Postgraduate Department of Economics, University College, Thiruvananthapuram, Kerala.

CONTENTS

Chapter

The Global Financial Crisis: Origin, Features and Challenges

1

Roy Scaria

I. The Global Financial Crisis: Origin

The global financial crisis was broke out as a consequence of the excessive inflation and housing market bubble burst in the US economy in 2007-08. The increased financial globalization since 1970 has eventually contributed a great deal to spreading the crisis, to different parts of the globe, in varying degrees. The crisis has serious implications to the world output, inflation, employment and income distribution.

Though the proximate immediate causes of the American housing boom burst cycle are manifold, the single most important or fundamental factor was pre crisis low interest rate and increased credit growth. Further, it was fueled with increased deregulation of financial markets and favorable taxation treatment of mortgages.

1. Lack of proper regulation of monetary expansion under financial globalization (Arestis and Singh).
2. Misallocation of resources to real estate, financed through the issuance of exotic new instruments and monetary easing caused to start building the bubble. (Diamond and Rajan 2008).

3. Widespread securitization of assets whose value has been inflated (Tobias et al. 2009).

4. Bubble burst was due to tight monetary policy and consequent rising interest rate for containing inflation. The prices of housing property cease to rise and as a result the trust in credit markets collapsed (Gorton 2009).

It is worth to state that on the eve of the crisis, the world economy was "flooded with liquidity" (Tobias et al. 2009).

II. Features of the Crisis

1. A Monetary Explanation to the Crisis

With many other economists, John Taylor remarked that the US real estate crisis fits well to the classical explanation of financial crisis as a natural outcome of monetary excesses (Taylor 2009). Quite often, the neoliberal monetary policy stance is also blamed for its single objective of price stability to be pursued by manipulating a single variable, the rate of interest (Arestis and Singh). The excessive money supply theory in a wider framework asserts that excessive money supply; eased monetary regulatory systems, the resulting excessive risk taking and the interconnections among them are the major determinants of asset price bubbles.

2. Building over Optimistic Speculation

At the root of most financial crises is the over optimistic speculation built up on the low interest rates and liberalized regulatory mechanisms for credit expansion. For example, the dot-com bubble in the US at the end of the 1990s can be seen as an outcome of the over optimistic view of investors about the US economy in respect of technological advancement coupled with monetary easing. Monetary easing in a less regulatory framework, inturn, caused for increasing demand for financial

assets for earning profit. Since, the credit availability is 'easy' at a 'low cost', investors find it comfortable to borrow and make investments in the stocks of dot-com companies without proper assessment of the probable risk of incurring losses.

However, soon the Fed initiated a counter cyclical monetary policy stance and it helped to wind up the recession in 2000-01. It initiated an increase in the Fed discount rate in 2004. The investors were quite unwilling to accumulate their idle money; they want to find a safe and profitable 'parking ground' for their excess money. Following the traditional wisdom, much of the dot-com money finds its way to the real estate, the price of which had been believed to be steadily rising over time (Savic 2008). Redirection of money flow from the stock market to the housing market added total demand and triggered the housing prices up which, in turn, made housing more glittering and attractive arena for profitable investment. Higher prices attracted more investment and even tapped foreign savings. In fact, many people purchase houses for flipping profit. This coupled with growing domestic consumption associated with purchasing new houses created a gap between saving and investment and it compelled the bank to borrow to reconcile the external imbalance.

The external imbalance of the US, to a certain extent, was aggravated by the accumulation of foreign currency reserves by China, the emerging global power. Experts describe it as the 'global saving glut' in which China persistently enjoy current account surpluses. As Tojo argues (Chapter 5), China might have the hidden agenda to place its currency in the international currency basket.

During 2003-2005, growing housing asset prices and growth of consumer credit contributed significantly to adding

the aggregate demand and acted as an impressive growth engine. However, soon the situation dramatically changed when housing prices failed to increase. Panic about a fall in prices gets started and it, in turn contributed to a further fall in price. The fall in prices of securitized asset led to default of loan repayment. Simply, mortgage loans were not absorbed by mortgage backed securities (MSBs). Finally the US financial system collapsed. The economy fell into deepest economic crisis due to fall in aggregate demand unparallel in history since the great depression of 1929-33.

One can find a close connection between excessive risk taking and the low interest rate (Taylor 2009). Expectations that future prices (of real estate) will rise create strong incentives for repayments of mortgage loans. In the downturn where expectations are negative, the opposite happens. If the house price falls below the value of the mortgage, negative incentives for delinquencies and foreclosures are likely to shoot up.

3. Deregulation of the Financial System and Subprime Lending

Many economists believed that the crisis is the aftermath of the US official policies that aimed at increasing mortgages (subprime lending) for the middle class and low income people. It is interesting to note that the Government Sponsored Enterprises (GSEs) had been responsible for the unbridled expansion of mortgages. In this, it was argued that the GSEs had become instrumental in deliberately creating the real estate bubble and its bust.

Peter Wallison argued that Fannie Mae and Freddie Mac (Major GSEs facilitating housing mortgages in US) were the main vehicles for creating astonishing growth of the subprime loans.

Since 1998, Fannie Mae was offering mortgage with a 3% down payment, and in 2001 the down payments were abolished at all. By September 2008, the portfolio of Fannie Mae and Freddie Mac reached $5.3 trillion of own mortgages and Mortgage Based Securities (MBSs).

III. Challenges for Solution

1. Inability of Monetary Policy: The Liquidity Trap and Zero Bound

During the periods of collapse and turmoil, the pessimistic expectations about future make monetary easing by lowering the policy rate becomes ineffective. The economy is likely to fall in the so called 'liquidity trap' in which each additional quantum of liquidity is kept as idle balances for speculating in the future.

Continuous monetary easing is also very hard due to the zero lower bound. When crisis broke out, many central banks suddenly lowered their policy rates to very close to zero. If they follow the Taylor rule, they had to lower the interest rate another 3 to 5 per cent. However, the zero lower bound prevents the banks to do so. The Taylor rule stipulates that a change in the nominal interest rate is in response to divergences of inflation rates from target inflation rates and of the GDP gap. As it is widely considered, a systematic use of such a rule brings about price stability and full employment through reducing uncertainty and increasing credibility of future actions by the central bank.

Many countries attempted to settle the crisis by managing other monetary variables. Central banks then began to adopt nonconventional policies of targeted easing and/or quantitative easing. The former refers to the purchases of specific financial assets without a change in the money supply whereas the latter

mean purchase of assets which are not sterilized, hence leading to an increase in the money supply. However, the evidence of success of these policies was mixed.

2. Interest Rate Targeting For Developing Countries (India)

We call developing economies as 'emerging economies' because they are at the threshold of surpassing the world economic power or at least becoming equal shoulder height position. Even though, they have to fulfill growth and distributional objectives in their effort to frame macroeconomic policies.

Many notable economists including RBI Governor Raghuram Rajan advocated for targeting inflation through fixing a medium term Interest rate Target (IT). Inflation targeting is similar to Interest rate Targeting (IT) in that, in a 'single objective' and 'single instrument' policy rate regime, inflation and interest rate has a one to one relationship. They are of the firm belief that IT produces commendable results on the objective of stable exchange rate as well. IT, they argue, has implications to the independence of administration of RBI from the Government of India (GoI) and political pressures.

However, a large number of economists who include Subbarao, Reddy, Jha and Jalan have the opposite view. They argue the realities that India faces are quite different from the western world where the IT is more suitable. 'More suitable' doesn't mean that it is perfectly suitable and always successful. The emerging economies have to address the development requirements on the one hand and distributional aspects on the other through poverty alleviation and employment generating programmes. They further remark that the

Monetary Transmission Mechanism, strength of which is a pre requisite for effective implementation of IT, is weak in India.

On the eve of present Global Financial Crisis and its 'spillover effects in India, it should be affirmed that the current 'multi- objective' monetary policy strategy, to a certain extent, has been successful in maintaining more or less stable inflation, and a slightly devalued currency leading to increased exports and hence growth.

3. Containing Food Inflation

One of the major objectives of monetary policy in a developing economy is to contain inflation in general and food inflation in particular. This, in fact, has important distributional implications in emerging economies.

In developed economies, the major cause of inflation is growing demand (demand pull factors) which is quite easy to be tackled by variable interest rates. However, in the emerging economies, supply shocks due to oil price hikes, domestic supply bottlenecks (cost push factors) deepened by the global integration of economies and random forces are the principal factors contribute to (food) inflation. The monetary policy is unable to reduce inflation here, and any effort to suppress liquidity for containing inflation would adversely affect the already depressed supply forces; inflation will be further triggered.

Difficulties for Fiscal Initiatives

The difficulty of manipulating monetary variables for desired ends during the crisis is the clear indication for a policy stance in favour of fiscal management to sustain demand. In fact, it was the fiscal policy that helped to stimulate aggregate demand during the post depression period of 1929-33. However, during 1980s and 90s fiscal policy was pushed to the

back seat behind monetary policy. Monetary policy with the development of financial markets becomes easier to implement and found successful to control inflation. Since 1960s for a long time, the advanced countries experienced more or less stable inflation and output gap (difference between potential and actual output) with the manipulation of a single variable the policy rate. This was misinterpreted as the success of monetary policy.

Fiscal policy, on the other hand, lost its relevance during the pre crisis period due to long implementation and outcome lags, uncertainty of outcomes and lack of empirical evidence regarding specific package of components to be adopted for pre defined ends.

Desperate about monetary policy, many countries turned to fiscal policy. However, they found it hard to implement suitable fiscal policy package due to manifold reasons.

1. During the pre crisis period, there was no significant research undertaken for making available historical information which would be helpful to adopt apt fiscal package to manage the crisis.
2. Mounting public debt which for some developed countries exceeded 100% of GDP and still increasing.

In fact, the feasibility of inducting fiscal stimulus depends on the available fiscal space which is largely defined by the revenue growth rates, dynamics of government expenditure rates and debt GDP ratios.

The Debt Crisis

During the period of crisis, the debt GDP ratio increased in both developed and emerging economies. In the US, the debt

GDP ratio exceeded 100% in 2012 from the safe position of 60% at the start of the crisis. This was not simply due the fiscal stimulus initiated but drastic decline of revenue resulting from low economic activity. Thus, a safe debt position in the pre crisis period is not as safe as visualized.

For instance, the real estate bubble bust seriously affected the construction industry, which is used to be considered one of the most important engines of growth in the US. Though the growth rate of homes in the pre crisis year 2005 was 6.5%, in subsequent years it reversed. The negative growth rate was 14.6% in 2006, 28.6% in 2007, 40.5% in 2008, and 28.5% in 2009.

Concluding Remarks

The above analysis gives a vivid picture of the world financial crisis, characteristics and major challenges that remains for solution. Admitting the fact that cycles are common in capitalist economies, the responsibility of rulers and policy makers is to correctly predict future economic conditions based on available information and design counter cyclical policies to subside its severity. Over confidence in deep monetarism and huge fiscal doses are equally harmful. The 'financial crisis hit economies' can open more rooms for fiscal adjustments and consolidation. In the long term, the Keynesian principles are still relevant, as it did a good job in healthing to recover major economies from the Great Depression -1929-33, in managing the present economies from falling into devastation. What is required is to ensure greater synchronization of both monetary and fiscal measures. Much research has to be undertaken while framing the synchronization to determine the relative role of each one suitable to the policy requirements of each economy within the broad groups, developed and emerging economies.

References

1. Arestis, P., and Singh, A. "Financial globalization and crisis, institutional transformation and equity". Cambridge Journal of Economics. Vol. 34. No. 2 (March). P. 225–238.
2. Diamond, D., and Rajan R (2009). "The Credit Crisis: Conjectures about Causes and Remedies". American Economic Review. Vol. 99. No. 2. P. 606–610.
3. Gorton, G, (2009). Information, Liquidity, and the (Ongoing) Panic of 2007. American Economic Review. Vol. 99. No. 2. P. 567–572.
4. Olivier Blanchard et al., (2013). "Rethinking Macro Policy II: Getting Granular". IMF Staff Discussion Note of IMF.
5. Olivier Blanchard et al., (2010). "Rethinking Macroeconomic Policy". IMF Staff Position Note of IMF
6. Savic. I, (2009). "Today's Financial Crisis: Lessons from the Past". Toronto: University of Toronto, P.10.
7. Taylor, J, (2009). "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong". NBER Working Paper No. 14631. Cambridge, Mass.: NBER.
8. Tobias, A., and Shin, H, (2009). "Money, Liquidity, and Monetary Policy". American Economic Review. Vol. 99. No.2. P. 600–605.

A Brief Resume of the 1990s Synthesis and Interest Rate Targeting in India

2

G.Visakh Varma

I. Principles of the 1990s Synthesis

The basic principles of the 1990s synthesis are the following:-

1. Overall price stability which should be recognized by law, treaty, pact or code. Price stability should be given definition and transparency by adopting one or more explicit targets. But of the various targets "target of inflation" is the increasingly preferred option.

2. Price stability should be achieved through the exercise of monetary policy (MP). But it is not the only objective of monetary policy, there are other objectives also. Price stability should be pursued through the active use of market-based monetary instruments, principally through short-term interest rates.

3. Responsibility for monetary policy, and thus for securing price stability, should lie exclusively with Central Bank (CB). Through statute, CB must be free from political interference, or, at least must have full autonomy in the conduct of MP. This implies a clear separation of responsibility for MP from that of fiscal policy (FP).

4. The task of FP is to support MP in achieving price stability. In order to facilitate, fiscal instruments should be set to keep the government in broad financial (budget) balance over the medium and longer term. The instruments should be passive in the face of cycles and shocks that are not actively managed.

5. A large public sector (PS) in relation to GDP is undesirable on both efficiency grounds and counter-inflation grounds. Privatisation of PS enterprises, cutting subsidies and social security benefits and the reduction of overall tax burdens are recommended.

6. In normal circumstances, countries should allow their exchange rates to float freely, apart from minor smoothing. This is not applicable to (a) those that have joined a monetary union, (b) those who aspire to join a monetary union, and, (c) for small open economies.

7. In contrast, developing and emerging market-economies should link their currencies to an external currency via pegged-exchange rates with the help of (a) IMF or a regional bank, (b) bilaterally and less formally with a major trading partner. Those concerned to control inflation should link to a strong currency ($, Euro), those seeking stable external trading should stabilise their real (inflation adjusted) ER against main trading partners.

8. Banking and financial systems should be liberalized so far as possible subject to effective regulation on prudential and anti-cartel grounds. Complete removal of administrative controls and mandatory reserve requirements on banks and other credit institutions on activities like (a) deposit banking, (b) mortgage lending, and (c) investment banking.

9. International trade (INT) should be liberalised so far as possible, subject to (a) protection for infant industries in developing economies, and, (b) for industries that are essential to national defence and security. In return to free access to markets for manufactures and services throughout the developed world, the protection and subsidisation given widely to domestic agriculture in developing economies will be removed.

10. There should be periodic multilateral policy consultation between the largest developed economies via the G7/G8 group of finance ministries and CB governors, and regular policy surveillance should be exercised overall market economies by the IMF through Article IV Consultations. However, surveillance carries no obligation for policy action unless a country seeks IMF assistance.

All these principles were not universally embraced by the countries. Most developed economies subscribe to most of them. But only some developed countries subscribe to all principles.

II. Theoretical Foundations of the 1990s Synthesis

Theoretical foundations of the 1990s synthesis are the following:-

1. The revival of free-market economics.
2. The onward march of globalization.
3. The influence of rational expectations.
4. The Phillips Curve and the NAIRU.

5. The 'New Macroeconomics Consensus' Model.

6. The attachment to exchange rate floating.

7. Output stabilisation as a subsidiary objective

The four aspects of MP according to the synthesis are:-

The CB uses MP instruments to achieve an outcome for an intermediate target so as to control its ultimate target inflation, the operational instrument of MP are short-term interest rate and VRR, intermediate targets are indicators with a reliable connection with future inflation, and, ultimate policy target is normally inflation, but could also include reference to output and employment.

III. India's Monetary Policy and Inflation Targeting Debate

There is a fake concern about inflation. Ignoring the cost-push causes of inflation like oil price hike, some experts insist that excess demand (demand-pull) is the cause of inflation in India. The RBI, the Chief Economic Advisor, and the Prime Minister's Economic Advisory Council (PMEAC) all argued that not hiking petroleum products' prices would mean a higher fiscal deficit and would add to excess demand, and thus result in higher inflation. The rulers respond to inflation through hikes in interest rates, but successive interest rate hikes had little effect on prices .Why do we find that the rulers' only response to inflation today is hike in interest rates? The LPG policies deepened the agrarian crisis. At the same time speculative forces have been strengthened through commodity futures markets and finance has been made easily available

for speculators. Regulations on movement and storage have been eased. State agencies' intervention in agricultural markets has been withdrawn. As a result of all these, any period of sustained growth triggers inflation.

Under a pro-people order, inflation could be curbed by direct state intervention to boost agricultural investment and production, suppress speculation, expand public procurement and distribution, ration scarce essentials, reduce the burden of taxation on petroleum imports, and insulate the domestic economy from global swings. However, under LPG, the only instrument left with rulers to address inflation is to raise interest rates in order to curb growth and depress demand.

For the past three or four years, Indian economy was forced to accept a narrow monetarist policy stance with the objective of fighting largely supply-induced inflation. All expected a change when Raghuram Rajan took the charge of Governor of the RBI. However, his intention was to pursue a single objective, that is, inflation control with a single instrument, that is, the repo rate (raising repo rate by 25 basis points). On the other hand, in what appeared to be a minor concession to those arguing that easy and inexpensive liquidity was needed to boost demand and flagging growth, he choose to lower the interest rate on the RBI's Marginal Standing Facility (MSF), established in 2011, under which banks can borrow funds at a rate linked to but set higher than the repo. Thus, there appeared to be two contradictory planks to RBI policy. Keep interest rates high to curb excess borrowing in order to curb demand and fight inflation. Ease liquidity conditions so

that banks can lend to genuine borrowers who would, however, have to bear the burden that a higher interest rate implied.

The talks about inflation targeting in India started in the late 1990s and were heightened after the Reserve Bank of New Zealand's Governor delivered a speech during the L. K. Jha memorial lecture series in 1999 on how New Zealand's experience with Interest Targeting (IT) can be relevant for developing countries. Narasimham (2000) and Rajan (2007) Committees recommended the implementation of IT, with a fixed medium term target, in India. They felt that currently RBI does not have a clear objective and the inflation rates are residuals of various policies. IT will make RBI accountable and provide it complete autonomy to achieve its targets, without any intervention from the Parliament and the government. Rajan (2013), in his first speech as RBI Governor, again emphasized the importance of low and stable inflation for Indian monetary policy. RBI can cut short term interest rates to stimulate growth without a rise in inflation expectations. Narasimham Committee felt that if the RBI is successful at achieving inflation target, a low inflation rate would contribute to exchange rate stability as well. Rajan said that in the present multi-indicator approach, due to unpredictability of policies, there is an unpredictability in market participants' responses to policy actions, which in turn constrains the room for aggressive policy responses to shocks. But he also admits that financial reforms are required to improve transmission mechanism for the successful implementation of IT.

But there are others who are against implementing IT in India. Since 1998, India has been following the multi-indicator

approach, which according to Subbarao (2013) has been quite successful till now. Under this approach, a number of quantity and rate variables, such as credit, output, inflation rate, exchange rate, interest rate etc. are analyzed for making the monetary policy. Central banks' objective is to maintain price stability, growth and external sector management and financial stability. Many central banks have development mandate as well. As per Reddy (2008), democratic pressures in India provide the monetary policy a disciplinary force, which in turn has allowed India to perform well in comparison to other developing countries. Jha (2008) also supports this fact by saying that the multi-objective approach prevalent in India has successfully maintained stable inflation, interest rates and a slightly undervalued currency, which has helped in promotion of exports and hence growth.

Jha further emphasizes that IT should not be implemented in India because India lacks proper conditions for successful implementation of IT, some of which are: adequately developed financial markets, confidence of global capital markets to enable a flexible exchange rate, independence of the RBI, more demand shocks compared to supply shocks, high frequency data requirements and an appropriate measure of inflation.

In India, the fiscal and monetary policies are not completely independent of each other and the interest rate transmission channel is also weak. Further, both Jha (2008) and Subbarao (2013) have explained that alleviating poverty should be one of the major concerns of India's monetary policy. This requires a sustained high GDP growth in the country. But there

is an inherent trade-off between growth and inflation. In a developing country like India, which is largely non-monetized and agricultural, this trade-off becomes much more important. Jalan (2000) also mentioned in this regard that in case of such a trade off in the short term, transmission lags and uncertainty about the future can render such a mechanistic and narrow rule ineffective. In his opinion, the view on "one target, one instrument" won't survive for long. According to Subbarao (2011), one of the factors which makes this complicated is the fact that, due to supply constraints and under-utilization of capacity, estimation of potential output and hence output gap becomes difficult. Thus, this trade-off has to be dealt with utmost caution and judgment. He also reiterated that India being an emerging economy, it is not wise for RBI to ignore the larger development context. He gave evidence from the 2008 crisis that due to IT; many central banks could not cope up with the increased financial innovation and global imbalance.

Monetary transmission mechanism is another necessary condition for the implementation of IT. Mohan (2007b) says that India lacks an efficient monetary transmission mechanism which would make it difficult for IT implementation. But for developing nations like India, supply shocks (for e.g. effect of monsoons on agriculture) rather than demand shocks are the major reason for inflationary pressures. According to Jha (2008), Mohan (2007a) and Subbarao (2011), monetary policies can stabilize inflation only caused due to demand shocks, and are ineffective against supply shocks. In fact, IT policies will lead to a reduction in demand and thus make worse the recessionary effect on output (Jha, 2008). Also, as per Subbarao (2013), in

case of emerging economies it is not easy to determine whether the supply shock is temporary or structural, a necessary pre-condition for the decisions of the central bank.

Another major point highlighted is the absence of a proper measure of inflation in India. In terms of frequency of release and coverage of commodities, WPI is better than CPI. But WPI doesn't include services, thus won't be representative of economy due to the very big share of services in GDP. Also, there are large biases due to the weights and base year of the indices. CPI, which is indicative of the standard of living, diverges significantly from WPI. Finally, the quality of data and consistency are quite poor in India. In both Reddy's (1999) and Kannan's (1999) opinion, GDP deflator is the best measure for inflation as it includes all economic activities, but due to its very low frequency of release of one year, that too with a long lag of a year, makes its use unviable.

References

1. Jalan, B. (2000). "Inflation and Growth". 11th C.D. Deshmukh Memorial Lecture, Mumbai.
2. Jha, R. (2008), "Inflation targeting in India: Issues and Prospects", International Review of Applied Economics, Vol. 22, No. 2, pp. 259-270.
3. Kannan, R. (1999), "Inflation Targeting: Issues and Relevance for India", Economic and Political Weekly, Vol. 34.
4. Mohan, R. (2007a) "India's financial sector reforms – fostering growth while containing risk", RBI Deputy Governor Address at Yale University.
5. Mohan, R. (2007b), "Monetary Management in Emerging Market Economies: Concerns and Dilemmas", RBI Bulletin, pp. 1965-1971.
6. Narasimham Committee Report on Financial Sector Reforms-1997.
7. Rajan, R. (2013), "Statement on taking office on September 4, 2013", Reserve Bank of India.
8. Reddy, Y.V. (1999). "Inflation in India: Status and Issues". in "Monetary and Financial Sector Reforms in India - A Central Banker's Perspective", UBS Publishers & Distributers Ltd., New Delhi.
9. Subbarao, D. (2011), "Inflation Targeting can't be a Formal Policy Goal", Meeting of the Central Bank Governance Group, Basel.
10. Subbarao, D. (2013), "Central Banking in Emerging Economies – Emerging Challenges", speech delivered at European Economic and Financial Centre, London, July 17, 2013.

Managing Food Inflation in India: Does Monetary Policy Matters?

3

S.R. Keshava

Inflation poses a serious threat to the growth momentum. Whatever be the cause, the fact remains that inflation is something which needs to be tackled with great Urgency.

-: Manmohan Singh (2010)

I. Introduction

In the past two decades, there are many instances where the persistent increase in prices of onion, potatoes and other essential food items has led to fall of the government in the elections; and the party assuring bringing down of prices in 100 days had formed the new governments. It is generally agreed that a moderate inflation is acceptable. Generally, monetary and fiscal economists opine that an acceptable moderate rate of inflation is desirable as it prevents stagnation, provide optimistic outlook, help mobilize resources, boost investment and production. In this regard Tarapore Committee (1997) opined that 3 % inflation in India is acceptable, while Chakravarty. S Committee (1985) finds that an increase in price of not more than 4 percent is acceptable, whereas Rangarajan.C (2012) regards 2 to 3 % of inflation as acceptable, and 5 %

inflation as threshold inflation for India. Hence the acceptable range of inflation in India lies between 3 to 5 percent. The continuous increase in prices or inflation causes the heart burn to majority of Indians as the Indian employment structure is tilted towards informal unorganized sector.

In India, 92 % of the workforce is employed in unorganized sector. In the unorganized sector workers neither has regular tenure or receives regular or fixed wages nor is eligible for paid, sick or annual leave or for any social security benefit by the employer. 'A high proportion of socially and economically underprivileged sections of society are concentrated in the informal economic activities' (Report of the Committee on Unorganized Sector Statistics 2012). To name few, small and marginal farmers, landless agricultural labourers, share croppers, fishermen, those engaged in animal husbandry, beedi rolling, labeling and packing, building and construction workers, leather workers, weavers, artisans, salt workers, workers in brick kilns and stone quarries, workers in saw mills, oil mills, agricultural labourers, bonded labourers, migrant workers, contract and casual labourers, toddy tappers, scavengers, carriers of head loads, drivers of animal driven vehicles, loaders and unloaders, midwives, domestic workers, fishermen, barbers, vegetable and fruit vendors, news paper vendors, cobblers, hamals, handicraft artisans, Handloom weavers, Lady tailors, Physically handicapped self employed persons, Rickshaw pullers, Auto drivers, Sericulture workers, Carpenters, tannery workers, power loom workers etc come under the organized workers.

The picture get more clear when one realize that 39 crores (32%) live below the poverty line (World Bank, 2014) in India; 56% of total cultivated land is under dry land farming where poor marginal and small farmers gamble with monsoons. The employees in unorganized sector, poorest of poor, disadvantaged sections are affected much by the rise in prices. Moreover neither the producers nor the consumers are benefitted due to price instability. But the sustained high level of inflation hurt everybody though in different degrees. Hence the price stability is concern of the governments all over the world.

Inflation: Global and India

(Year-on-year in per cent)

	2000 - 07	2008	2009	2010	2011	2012	2008-12	2013-14
	Average	Annual					Average	Annual
Global Inflation								
World	3.9	6.0	2.4	3.7	4.9	4.0	4.2	2.7
EDEs	6.7	9.3	5.1	6.1	7.2	6.1	6.8	5.33
Inflation in India								
WPI	5.2	8.1	3.8	9.6	8.9	7.6	7.6	8.94
WPI-Food	3.8	8.9	14.6	11.1	7.2	9.1	10.2	
WPI-NFMP	4.3	5.7	0.2	6.1	7.3	5.2	4.9	
CPI-IW	4.6	9.1	12.2	10.5	8.4	9.9	10.0	9.68

Indian inflation data pertains to financial year,

DEs: Emerging and Developing Economies,

WPI: Wholesale Price Index,

NFMP: Non-food manufactured products,

CPI-IW: Consumer Price Index for Industrial Workers.

Inflation rate in India in post economic reforms more so after 2000 has been higher than world average. The world

inflation averaged 3.9 % per annum, during 2000 to 2007; the emerging and developing economies during the same period recorded 6.7%, while India's inflation was 5.2 % better than EDEs and worse than world average.

The inflation measured by WPI is continuously far higher than world average from 2000 to 2014. The Indian average is higher than even emerging and developing economies since 2010, which is a great cause of concern.

II. Reasons for Higher Food Inflation in the World

Since global recession in 2007, there is increase of 35 % in the food prices according to FAO's world food index. There has been significant rise in the prices of food grains mainly of rice, wheat soybean and dairy products.

The important reasons for food inflation as revealed by the literature on the area are

1) Transmission of the global food inflation

2) Increased Fiscal Deficit and current Account Deficit of the world economies.

3) Rising farm wages

4) Reduction in world investment on agriculture. It was 20% in 1980's which reduced to 3 % during 2000 to 2012.

5) US and developed world used huge food stocks mainly jowar and soybean to produce ethanol, a biofuel.

6) The agriculture inputs prices have increased enormously, for example urea which was 175 $/ 1 ton in 2004 increased to 415 $ / 1 ton by 2008.

7) Successive drought in Australia for 4 years since 2007 to 2010.

8) Agricultural production in Ukraine reduced significantly.

9) Snow fall in USA which resulted in reduction in agriculture production.

10) There has been enormous increase in current account deficit in the world economies in post recession period.

11) Economic prosperity of India and China

IV. Monetary Policy Effectiveness in India

RBI, with the intention of bringing down inflation went on hiking the Repo rates, 14 times (2009-10 to 2013-14) successively! But the food inflation despite good monsoon did not budge. The inflation in India, more so food inflation is predominantly a supply side constraint. Repo Rates was successively increased so that high interest rates would encourage savings and discourage investment there by reducing the demand for the goods. But this did not work, prices increased unabatedly despite the efforts by RBI. Hence the common man is faces the brunt of price rice of essential commodity. Governments including one where policy paralysis struck the macroeconomic fundamentals and the one with minimum government, maximum governance seems to be missing its strategy on curtailing food inflation in India.

Does it mean the failure of RBI's monetary policy in controlling inflation? Is RBI missing out in its monetary policy to control inflation? The monetary fools become redundant in the changed economic scenario. Are the conditions beyond the RBI to control inflation? Before answering to these questions, let us first see the important monetary tools of RBI in India.

India monetary policy framework revolves round the Bank rate, OMO, (1) The repo rate (2) The MSF/Bank rate (3) CRR (4) Reverse repo rate (5) LAF window cap (6) MSF window cap (7) Minimum CRR to be maintained (8) SLR.

Monetary Management of RBI

RBI under the RBI Act 1934 and Banking Regulation Act 1949 has two important controls of credit namely 1) Quantitative and 2) Qualitative credit control.

V. Quantitative Controls

1. Bank Rate Policy or Discount Rate Policy

BRP is one of the oldest and principle methods of credit control.

"The rate at which the RBI discounts the commercial papers of the commercial banks" is called as Bank Rate Policy. The RBI in its role as lender of last resort is approached by the commercial bank to accommodate them. It discounts the commercial papers of the commercial banks at a lower rate giving less money to commercial banks. Then commercial banks in turn will increase the rate of interest on the credit and the investors do not take more credit as interest rate is high and vice versa.

In narrow sense, the bank rate may be defined as the minimum official rate at which the central bank rediscount the first class bills of exchange brought to it by the discount houses and commercial banks. In broad sense, the bank rate may be defined as varying of the terms and conditions, under which the market can have the temporary access to the central bank either in the form of rediscount or through secured advances.

The bank rate and other interest rate move in the same direction. If there is any change made by the central bank in the bank rate, it will lead to corresponding changes in interest rate of the market credit, cheaper or dearer as the case may be.

Limitations of BRP

1. Increased liquidity in the assets of commercial banks.
2. Lack of eligible commercial papers with commercial banks.
3. No direct relation between interest and investment.

2. Open Market Operations (OMO)

The deliberate and direct buying or selling of securities and treasury bills in open market in order to attain desired monetary objectives by RBI is called as Open Market Operation.

In economy, when there is excess money supply, RBI sells its securities in open market and money moves the into RBI and money supply will be curtailed in the economy. If the RBI plans to increases the money supply, it buys securities and Treasury bill from the individuals in the economy and thereby increasing money supply.

Limitations of open market operation

1. Lack of well developed securities market.
2. Non existence of direct access of commercial banks to the RBI. Open Market Operation are more effective in controlling credit than expanding the credit.

3. Cash Reserve Ratio (CRR)

Variable Cash Reserve Ratio as an objective of monetary policy was first suggested by J.M. Keynes. It was first followed by Federal Reserve System in United States of America. The

commercial bank as per the statute has to maintain reserves based on their demand deposit and fixed deposit with central bank is called as Cash Reserve ratio.

If the CRR is high, the commercial banks capacity to create credit will be less and if the CRR is low, the commercial bank's capacity to create credit will be high.

Reasons for CRR

1. To ensure the liquidity and solvency of individual commercial banks
2. To influence and restrict the commercial bank from expanding credit, during inflation.

4. Statutory Liquidity Ratio

CRR is regarded as primary reserve, while SLR is regarded as secondary reserves which as per the statutes is additional reserves apart from CRR. Commercial bank has to maintain the reserves.

Statutory Liquidity Ratio (SLR) is the amount which a bank has to maintain in the form of cash, gold or approved securities. The quantum is specified as some percentage of the total demand and time liabilities (i.e. the liabilities of the bank which are payable on demand anytime, and those liabilities which are accruing in one month's time due to maturity) of a bank.

The objectives of SLR are to

1) To restrict the expansion of bank credit
2) To augment the investment of the banks in Government securities and
3) To ensure solvency of banks.

5. Repo and Reverse Repo Rates

Repo refers to Sale and Repurchase Agreement. Repo is a swap deal involving the immediate Sale of Securities and simultaneous purchase of those securities at a future date, at a predetermined price. Repo rate helps commercial banks to acquire funds from RBI by selling securities and also agreeing to repurchase at a later date.

Reverse repo rate is the rate that commercial banks get for parking their short term excess funds with RBI. Repo and reverse repo operations are used by RBI in its Liquidity Adjustment Facility. RBI contracts credit by increasing the repo and reverse repo rates and by decreasing them it expands credit.

6. Selective Credit Control or Qualitative Credit Control

Quantitative is non discriminatory and hence affects essential sectors and other sectors alike, whereas, the selective credit controls are selective and can be targeted to those areas where inflationary tendencies are high. For example; Speculators, hoarders

The Important Selective Credit Controls are

1. Rationing of Credit
2. Regulation of Consumer credit
3. Margin requirement
4. Moral Suasion
5. Publicity
6. Direct Action
7. Discriminatory Interest Rate (DIR)

7. Margin Requirement

The margin is the difference between market value of securities and loan amount sanctioned by the bank. RBI fixes the margin and higher the margin, lesser will be the loan amount sanctioned by the bank.

This rule was first applied to stocks and shares and later on the goods stored in authorized warehouses and other speculative activities.

8. Regulation of Consumer Credit

This method is adopted by RBI in order to curb the consumption of durable consumer goods, which led to the rise in the inflationary tendencies. The Regulation of credit was done in many ways,

1. By curtailing the credit all together to consumer durable goods
2. By curtailing the minimum down payment (the initial payment made by customer using the purchase)
3. By lessening the installment payments
4. By hiking the rate of interest.

9. Control through Directives

RBI through written orders, appeals or by warning to commercial banks enforces the credit controls. These directives will be issued depending on business cycle phases in the economy.

The main intention of RBI is to

1. Control the lending policies of commercial banks
2. To divert credit to essential necessary things from less essential credit

10. Rationing of Credit

Rationing implies fixing the limit on rediscounting facility or fixing the quota for the commercial bank for the financial accommodation from the RBI.

11. Moral Suasion

Moral Suasion involves advice, request and persuasion by RBI to commercial bank to co-operate in controlling credit. The moral suasion does not have any legal sanction and hence no punishment if the commercial bank does not adhere to central bank regulations.

12. Publicity

In the words of Prof. De Kock, "Publicity includes publishing regularly the weekly statements of their assets and liabilities, monthly reviews of credit and business conditions and comprehensive annual reports on their operations and activities, money market and banking conditions, generally, public, finance, trade, industry, agriculture etc". The general public and commercial banks are supposed to do their part after seeing the financial statements in media in curtailing the money supply policies of the central bank are called as publicity.

13. Direct Action

The use of authority apex by body against commercial banks whose credit policies are not in tune with the central banks is called as direct action. The direct action is action against erring bank which may be in the form of refusal of discounting facilities and charging penal rate of interest on money borrowed beyond prescribed limit.

The method of direct action is most extensively used by the RBI to implement their credit policies. This method can be used to enforce both qualitative as well as quantitative credit controls by the central bank. The method is not used in isolation. It is used to supplement to other method of credit control. The method also involves the issuing of general instructions by the RBI to all the commercial banks. It may also take the form of special instruction by the RBI to the erring banks.

Direct action is used as last resort. The action against erring banks will be in form of central bank refusal to grant discounting facilities. The central bank may refuse to sanction further financial accommodation to a bank whose existing borrowing is found to be in excess of its capital and reserves. The central bank may start charging penal rate of interest in money borrowed by a bank beyond the prescribed limit.

14. Discriminatory Interest Rate (DIR)

Through DIR, RBI makes credit flow to certain priority or weaker sectors by charging concessional rates of interest. RBI issues supplementary instructions regarding granting of additional credit against sensitive commodities, issue of guarantees, making advances etc.

Limitations

1. Difficult to distinguish between productive, essential and other wise
2. Commercial bank cannot control the ultimate usage of credit as customer may take loan for different purpose and use it for others.
3. Commercial banks may manipulate the records to show all credit as essential and productive.

Now let us discuss how these tables become redundant and why they become less effective.

VI. Food Inflation in India

India's Inflation during the post liberalization period is fuelled by increase in the wages, fuel and food prices. The sluggish growth in the manufactured sector also had contributed its bit for rise in inflation. The food inflation in India is highest among the emerging economies of the world.

Many Western economists and even the president of influential economy blamed the economic prosperity of India for the rise in global food inflation. The world bank, IMF trained Indian economists as well as the planning commission also spoke in the same tone. Raghuram Rajan, chief economic advisers of Government of India in September 2012 toed the same line. 'One of the concerns of the last few years has been food inflation, which has been not so much within the control of the government, but which has been sort of because our population has become richer, a good thing and therefore demanded more sort of higher end food products like, milk, egg, meat rather than the old cereals,……. Food inflation has hovered above the 10 per cent mark for most part of the current fiscal, only to decline to 9.14 per cent in August 2012. The overall inflation stood at 7.55 per cent' (Raghuram Rajan September 2012).

The Arjun Sengupta Committee (2006) appointed by the prime minister Manmohan Singh found that that 77 % of Indians live on a consumption expenditure of less than INR 20 a day. If majority lives on lesser amount with whose prosperity is food inflation increasing?

The quarterly policy review document of RBI (2012) states that the increased inflation is due to the demand side pressures (increased pricing power) and capacity generating inflationary forces and elevating inflation expectations. Non food items like fuel products, iron are and electricity contributed 70 % to WPI in June 2012 which indicated that food was no longer dominant factor.

Despite the contradiction from the government quarters, the food and fuel continues to be dominating factors that fuel inflation. Food is a highly sensitive issue in 1.2 billon population country and hence the governments put the onus on economic prosperity! Despite the fact that average Indian households accounts for almost 55 % of their total expenditure on food. The west which claims globalization increases prosperity also safely attributes economic prosperity as the cause for food inflation. The research by institute of economic growth (2012) has found that 1 % increase in per capita income would increase the per capita consumption of vegetables, fruits and milk in between 0.5 % to 0.6 %. Whereas 1% increase in per capita leads to a 0.05 % decline in demand for cereals and 0.2 % decline in demand for pulses (Institute of economic growth, 2012).

But the academicians, researchers, as well as government know that the economic prosperity theory and inflation is not the complete truth. But the partial truth!

Average Monthly Consumer Expenditure per Person on Food and Non- Food items- Rural (July 2009- June 2010)

Consumption of Different Groups of items per Person for a Period of 30 days in Different NSSO Rounds

TABLE 1

Items	Average expenditure per person at current prices (Rs./Month)			
	43rd Round (1987-88)	50th Round (1993-94)	61st Round (2004-05)	66th Round (2009-10)
(1)	(2)	(3)	(4)	(5)
Cereals	**41.33**	**68.13**	**100.65**	**145.09**
Gram	0.38	0.54	0.73	1.48
Cereal substitutes	0.21	0.28	0.39	0.66
Pulses & products	6.27	10.72	17.18	34.23
Milk & Products	**13.63**	**26.72**	**47.31**	**80.16**
Edible oil	7.88	12.43	25.72	34.15
Egg, Fish & meat	**5.11**	**9.37**	**18.60**	**32.26**
Vegetables	**8.23**	**17.01**	**34.07**	**57.20**
Fruits & nuts	2.57	4.89	10.42	14.88
Sugar	4.51	8.57	13.25	22.63
Salt & spices	4.52	7.43	13.90	22.33
Beverages, etc	**6.18**	**11.69**	**25.37**	**52.03**
Food Total	100.82	177.77	307.60	497.09
Pan, tobacco & intoxicants	5.03	8.97	15.03	20.60
Fuel & light	11.77	20.69	56.84	87.79
Clothing	10.52	15.12	25.33	45.51
Footwear	1.55	2.48	4.24	9.25
Misc. goods & services	22.78	48.70	130.52	223.06
Durable goods	5.64	7.67	19.23	44.42
Non-Food Total	57.28	103.64	251.19	430.62
Total Expenditure (Rs).	158.10	281.40	558.78	927.70
Price deflator @ MOCE (Rural): base 158.10	100 158.10	176 159.89	319 175.17	494 187.79

Source: GOI, NSSO, Household Consumer Expenditure in India, 66th Round

The consumption expenditure on food items is decreasing over the years. But still it constitutes the majority. In 1987-88

the food items expenditure was 63.7 % while non food expenditure constituted 36.8 %, in 2004-05 the food expenditure constituted 55 % while the non food expenditure constituted 44.9 %, in 2009-10 the food expenditure constituted 53.5 % while non food expenditure constituted 46.4 % of total consumer expenditure.

NSSO's household expenditure survey indicates that the share of protein rich items in overall food consumption has increased from 27.1% in 2004-05 to 32.5% in 2011-12 in rural areas.

In urban areas it increased from 29.9 % in 2004-05 to 33% in 2011-12.

VII. States' Average Monthly Consumer Expenditure

Average Monthly Consumer Expenditure per Person on Food and Non- Food items- Rural (July 2009- June 2010)

Sl. No	State
1	Andhra Prade
2	Assam
3	Bihar
4	Chhattisgarh
5	Gujarat
6	Haryana
7	Jharkhand
8	Karnataka
9	Kerala
10	Madhya Prad
11	Maharashtra
12	Odisha
13	Punjab
14	Rajasthan
15	Tamil Nadu
16	Uttar Pradesh
17	West Bengal
	All India

Source: GOI, NSSO, Household Consumer Expenditure in India, 66th Round

The average consumer expenditure is Rs 1053.64 in India where out of which Rs 600.36 was spent on food expenditure while Rs 453.29 was spent on non food expenditure. In majority of the states food expenditure is higher than non food expenditure; the exceptions being Kerala and Punjab where non food expenditure is higher than food expenditure. Higher the economic growth of the states, higher will be the average consumer expenditure of the individuals. In turn the states where the consumption expenditure is higher, one can observe that non food expenditure is higher than food expenditure.

The important reasons for increase in Food Inflation are:

1. MGNREGA has increased the wages in Rural India. Nominal wages has increased by 17.3% after 2008. The Government Commission for Agriculture costs and prices estimates that 1% rise in wage inflation translates into a 0.3 % rise in food inflation.
2. Input Costs in all sectors has increased significantly for example: Key agriculture inputs like fertilizers 8%, fodder 20%, diesel 8%, electricity 8.7%, and tractors 5.4% increased during 2008-2012.
3. Decrease in public investment in agriculture during post economic reform.
4. Decrease in the area of food grains cultivation.
5. The productivity of land is low than world average.
6. Demand pull inflation plays an important role in case of high value added items like fruits, vegetables and dairy products.

VIII. Recent Changes in RBI's Monetary Policy

Since Economic reforms RBI has used some modified techniques namely:

1. 'Multiple Indicator' Approach; where varieties of economic indicators were used to reduce and monitor the inflation.
2. Selective Methods Being Phased out: Quantitative methods are becoming more important and are taking the place of selective credit control.
3. Reduction in CRR and SLR Requirements: During post-reform period, more so after 2000 the CRR and SLR have been progressively lowered. As a result, more funds were available with banks for lending.
4. Deregulation of Administered Interest Rate System: Following the recommendations of Narsiman Committee Banks were authorized to determine the interest rates.
5. Delinking of Monetary Policy from Budget Deficit: In1994 government phased out the use of adhoc treasury Bills. These bills were used by government to borrow money from RBI to finance fiscal deficit. With phasing out of adhoc Bills, RBI is no longer lend to government to meet fiscal deficit.
6. Liquidity Adjustment Facility (LAF): LAF allows banks to borrow money through repurchase agreement from RBI to meet day-to-day mismatches in liquidity.
7. External Sector: RBI uses sterilization and LAF to absorb the excess liquidity that comes in with huge inflow of foreign capital.

8. Expectation as A Channel of Monetary Transmission: Interest rate, credit availability, asset prices and exchange rate are four traditional channels of Monetary Policy Transmission. Expectation has been added as fifth channel where future expectations about asset prices, general price and Income levels influence the four traditional channels.

IX. Monetary Policy does not matter!

The monetary policy does not matter as expected as

1. Huge budgetary deficit which makes monetary policy inactive.
2. Existence of unorganized financial institution on which RBI does not have control.
3. Increase in deficit financing makes monetary policy ineffective.
4. Increased volatility in domestic market due to integration of domestic and foreign exchange markets.
5. Lack of transparency in the RBI policy formulation and transmission process.
6. Increase in the presence of black money due to which monetary policy becomes ineffective.
7. The scarcity of goods and supply side constraints make monetary policy ineffective.

X. Monetary Policy Does Matter!

The existing monetary policy tools are taken from the west. They are not home grown to suit to the domestic credit needs of India. The Indian conditions are different due to supply bottlenecks, existence of unorganized sector; increase in corruption and black money, huge CAD and budgetary

deficit etc, which makes it ineffective. The monetary policy should be changed to make it more inclusive of unorganized financial sector. The unorganized financial sector should be bought into organized framework on the one hand and expanding the organized financial sector on the other. So that unorganized financial sector looks its sheen and acceptability.

References

1. S. Chakravarty(1985), retrieved from www.yourarticlelibrary.com / economics/...chakravarty-committee/2788/
2. C. Rangarajan (2012), 'India should grow keeping inflation rate in mind', retrieved from http://timesofindia.indiatimes.com/city/visakhapatnam/India-should-grow-keeping-inflation-rate-in-mind-C-Rangarajan/articleshow / 17802859.cms and www.thehindubusinessline.com/.../
3. Tarapore Committee (1997) Report of the Committee on Capital Account Convertibility retrieved from http:// www.rbi.org.in/Scripts/BS_ViewPublicationReport.aspx
4. Indian Economic Survey (2013-14), Government of India, oxford university press, New Delhi.
5. Anand R Patil, Sadashiv O Halasagi(2012), "Food Inflation: An Exploratory Study", Zenith International Journal of Multidisciplinary Research, Vol.2, Issue 4, April.
6. Deepak Mohanty(2011), "Inflation Threshold in India: An Empirical Investigation", RBI working paper series, Department of Economic and Policy Research, RBI.
7. Keshava.S.R (2009), 'Economics', New Age International Ltd Publishers, New Delhi.
8. Keshava.S.R (2014), 'Rupee Depreciation and Economic Problems', UGC sponsored National Seminar held on 26th & 27th September, at S.T. Hindu College, Nagercoil.
9. Report of the Committee on Unorganized Sector Statistics (2012), National Statistical Commission, Government of India.

Ideology and Policy Independence: The Dilemma of RBI

4

Santhosh T Varghese

I. Introduction

Policy independence is considered as a desirable feature of a central bank for rescuing the monetary policy from any inflationary bias stemming from the electoral compulsions of political masters. For instance, Alesina & Gatti (1995) pointed out that politically independent central banks bring about relatively low and stable inflation rates and mentioned about the empirical evidence available.(Cukierman, 1992), (Alesina & Summers,1993). Earlier, Sargent and Wallace (1981) showed that if the monetary authority independently sets the monetary policy by announcing first a fixed rule it will force the fiscal authority to choose a particular sequence that eventually imposes fiscal discipline by non-monetising the budget deficit. However Rogoff (1985) showed that it is only at the cost of increased output variability that an independent and inflation-averse central bank reduces average inflation. But Alesina & Gatti (1995) heaved a sigh of relief when they found that the variance of output is significantly lower with an independent central bank than that of the other.

Nevertheless, views from the other side are not that comforting as Rymes (1995-1996, p. 178) underscored that a rule-constrained central bank acting to produce price stability and price stability only implies that it is functioning withautonomy and given the danger that autonomy is synonymous with autocracy, the autonomy must be balanced by accountability. Carvalho (1995-1996, p. 166) apprehended the misuse of policy independence in a direction contrary to that decided by the government by deciding monetary policy without any consideration for an eventually opposite choice made by the government with respect to fiscal policies etc. If the central bank, rather than duly elected officials, chooses among various combinations of unemployment, inflation, and growth, it is violating democratic principles and therefore, democracy requires that central bank independence be limited so that the *makers of monetary policy cannot stray far from the will of the people* (Levy, 1995-1996).

II. Policy Independence and Interference

Quite conforming to the apprehensions raised above, the central bank of India in its recent report indicated that it has entered into a ramp where it has been seen as sashaying with an 'activist stance' It has been emphasised in the very first page itself that, "...In the near term, the objective of macroeconomic policies *should be to* secure a sustainable recovery" (emphasis not the text) (RBI, 2013, p. 1). In theory, macroeconomic policy making is an exclusive privilege of national government and any incident of usurpation of that by any outside agency could be considered only as an attempt of unnecessary intervention. The statement in the report is due to the absence of proper

reflection vis-à-vis its role and operational frontier and thereby amounts to 'activism' (Freire, 2005, p. 88) and should have avoided that *subtle* attempt to shape or set the macroeconomic policy. However in defining the contours of monetary policy and implementing its various tools, the central bank of a nation has enough elbow room given the growing consensus around the idea of 'central bank independence'. It is worth noting that treading outside one's own policy terrain *ipso facto* militates against the notions of 'independence' in decision making.

III. Inflationary Pressures: Ideological Analysis?

The corollary of the analytical angle emanating from the policy independence stance is surprisingly contradictory in nature when the RBI report discusses the reasons behind the inflationary spiral. The report indeed made an evaluation with the support of data regarding the inflationary situation with the following narration;

"Headline consumer price index (CPI) inflation generally increased during June-November 2013 driven largely by food price increases. The spike in vegetable prices, especially of onions, led to CPI inflation peaking at 11.2 per cent in November 2013. Food price corrections, largely on account of seasonal moderation in vegetable prices drove a subsequent fall in CPI inflation to 8.3 per cent in March 2014. Apart from the pressure from rising food prices, the sharp depreciation of the rupee in the H1 of 2013-14 led to pass-through effects, especially in the case of freely priced fuel products. Staggered revisions in administered prices of diesel also added to inflationary impulses. Even more worryingly, CPI excluding

food and fuel segment inflation remained sticky at around 8 per cent for most of 2013-14. Double digit inflation in housing and 'others' sub-category, which largely includes services, were the major drivers of inflation in this segment" (RBI, 2013, p.2).

Further, it has been stated that,

"...Increased input costs, driven by sticky nominal wages in rural areas partly fuelled by high food inflation and full indexation of Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) wages, also pointed to the role of wage-price spiral in keeping inflation elevated and persistent" (RBI, 2013, p. 3).

The contradiction in these two narrations are glaring in so far as in the first part it was *with the support of data* that the food and fuel prices especially of onion have been identified as the main reasons but later in the second part *without any hard data* it has been added that the increase in the input costs was due to sticky wages emerging from the full indexation of MNREGA as yet another reason for the elevation of inflation.

This contradictory approach is not accidental but meaningful laced with ideological considerations. In economic theory, wage is considered as factor price rather than an entity which straightaway increases input cost. The influence of factor price permeates through the functional relationship of production and unfortunately no explicit evaluation has been made in this respect to know the effect of factor prices upon inflation.

In theory, while advancing the formal definition of core inflation, Eckstein (1981) examined the role of factor prices in

inflation. He decomposed the headline inflation into three components namely core inflation, demand inflation and shock inflation and pointed out that "the core rate reflects those price increases made necessary by increases in the trend costs of the inputs to production" (1981, p. 8). It has been explained that the core inflation rate is a weighted average of the rates of increase of unit labour costs (wage inflation minus productivity growth) and the user cost of capital and nothing but the supply price of output that would emerge along a steady-state growth path (Blinder, 1982, p. 1306).

Notwithstanding the theoretical definition of core inflation, there exists no unanimity regarding the computational methodology of core inflation not only in the literature but in the context of India as well. (Das, John, & Singh, 2009) (Mohanty, Rath, & Ramaiah, 2000). The exclusion based measures are the popular and the widely used ones and they are found out by stripping the food, fuel and energy inflation from the headline inflation. RBI also follows the exclusion method[1] to find out the 'core component' of inflation. The RBI's 'core component' of inflation is not exactly the core inflation suggested by Eckstein and the only similarity lies in the removal of 'shock' creating volatile elements such as food, fuel and energy prices from the headline inflation.

In these circumstances, inflation measures computed by RBI, whether it is headline or core inflation, cannot be taken as measures that weigh up the influence of factor price movements

[1] "Though some moderation in CPI excluding food and fuel inflation is visible in recent months, the extent of moderation warranted by the significant growth….. slowdown is yet to manifest in CPI. Such rigidity in the core component of inflation points to the inertial ….." (RBI, 2014, p. 26)

upon inflation figures. Moreover, the factor prices influence the cost of production not in a single handed manner but through the technical relationships of production environment where domestic capital formation, capital-output ratio etc. plays decisive role. These aspects are unattended and unexplained in the report. That being the case, it seems that RBI's interpretation drive which argued that the increase in the input costs consequent to sticky wages emerging from the full indexation of MNREGA as yet another reason for the elevation of inflation is running out of steam.

Nevertheless, in an economy where every variable and their influences are interconnected and overlapping, stretching the enquiry into the further reasons behind the price movements of constituent items of inflation index cannot be circumvented. Again, if at all a study on the influence of factor prices is attempted, such study should have considered all factor prices rather than a selective analysis of factor price of labour alone. Unless explained, such analytical selectivity could be motivated either by the underlying ideological inclination often euphemistically referred as 'theoretical' considerations or due to some omission in the analytical process.

The attribution of full indexation of MGNREGA wages as a partial reason for the wage spiral is unconstitutional as well when it implicitly yet unequivocally underscores the message that this full indexation was a deleterious move. As rightly punctuated by Levy (1995-1996, p. 190) an independent central bank cannot be consistent with democracy if it pursues arbitrary, subjective policies and he found that (p. 191) in the reality monetary policy formulation is far from scientific and objective.

However, once it is decided to guarantee employment, watchdog institutions should be watchful enough to ensure the delivery of intended benefits by adopting every measure to protect the monetary benefit against any value erosion let alone the full indexation. The soul of emphasis upon 'governance' on the one hand and the clamour for denouncing 'poor and populist economics' on the other hand yearns to see the transfer of intended benefits in its immaculate form to the final recipient. Given this backdrop any failure to ensure the smooth flow of intended benefits to the eventual beneficiary should have created consternation but unfortunately it was the measures incorporated to protect the value of benefits that cause dismay to RBI! This unexpected stance of RBI is not baffling once we realise the simple yet surprising fact that beneath this subjective examination there exist profound 'theoretical' predilections. In fact, 'theoretical or intellectual inclinations' are a euphemism for ideological considerations. It has been highlighted that such ideological considerations exert profound sway upon every practical men who always pretend that they are virtually free from all intellectual influences (Keynes,1936, p. 383).

IV. Imposition of Viewpoints

Another consequence of subjectivity in the analytical frame is the floating of viewpoints as if they are empirical facts. Consider the appraisal of the challenges faced by Indian economy in the RBI report. It attempted to popularise viewpoints with the following observation that,

"…..increases in wage costs have been a major factor pushing up the cost of production in agriculture.....movement of labour into construction, implementation of the MGNREGA and its indexation….falling labour force participation rates in particular for women could explain the increase in rural wages in the recent period. While the increase in wages could be desirable from a social welfare point of view, wage increases in excess of productivity growth lead to a wage price spiral and make food inflation a self-perpetuating cycle" (RBI, 2013, p. 8).

Two aspects protrude in this evaluation. First is the enumeration of reasons for the increase in wage cost and the second is the unfounded revelation that the wage increase is excess of its marginal product. The latter observation is quite a dubious one and thereby begs closer scrutiny.

To dissect the accusation, the report observed that the rural wages have increased owing to MNREGA, its full indexation on the one hand and labour movement to construction sector and the lower labour participation rates of women on the other hand. The former could be thought of an institutional intervention while the latter is purely a market phenomenon where demand and supply rule the roost. Increase in the wage rate of unskilled labour due to market forces often attracts across the board condemnation but the same phenomenon for skilled labour or commodity prices is celebrated as triumph of market signalling. This one sided approach needs to be punctuated.

It is worth noting that, full indexation is only a measure adopted to protect the benefit from any value erosion and hence

justifiable. However, it is not a solitary voice from RBI alone but Economic Survey also maintained a similar argument that the increasing wages under schemes such as MGNREGA have reportedly created shortage of labour in the agricultural sector as well as caused a wage-price spiral (GoI, 2014:76). The posited wage-price spiral is not supported with any empirical finding and in its all possibility will become a wrong conclusion as the wage rates of such programmes are well below the minimum wage rates in a number of states[2]. It has been reported that despite the annual increase in wages under MGNREGA since 2011, minimum wages in more than a dozen states are still higher and was the reason why the Karnataka High Court had directed the Centre to pay MGNREGA wages in accordance with the Karnataka State Minimum Wages Act (Times of India, 2014).

Given the very low level of wages prevailing in the rural India, that too many a times lower than that of the mandated minimum wages rates, the argument without the support of empirical data that the wages are in excess of productivity is difficult to digest. In these circumstances, the indictment that wage increases excessive of productivity are causing wage-price spiral is only considered as an opinion rather than an empirical fact.

Moreover, the staggered price hikes attempted by the producers to protect the profit margins from the 'shock' elements in the inflation index and its consequent impact cannot be construed as a contribution to wage-price spiral in a strict sense as shock elements include not 'fuel and energy' costs also.

Shortage of labour might also have happened consequent to the implementation of MGNREGA but that is only a sequel of the prevailing feudal agrarian relations in the rural India. In fact the MGNREGA wages are salubrious not because it is acceptable from a 'social welfare view point' as observed by the RBI report but owing to its contribution in strengthening the market competition by buttressing the bargaining power of the weaker side in the labour market.

Unfortunately RBI is not interested in any comprehensive dissection of any of these issues rather only fascinated to put the blame upon the upward movement of wages excessive of productivity consequent to MGNREGA. As it has been seen that the MGNREGA wages are lower than that of the minimum wage rates in many states the question of wage-productivity gap lost all its meaning. In fact, productivity gains over wages may put a barrier against a possible wage-price spiral in a situation where the wages are not instantaneously adjusted with marginal product. But that will be a market situation in which competition is taking place imperfectly! Yet, *overall* productivity increase will strengthen the supply and will act as a cushion against possible shocks. The abysmally low level of *overall* productivity in the agricultural sector is an important concern upon which attention has to be concentrated but the RBI is not at all amused.

V. Recapitulation

Policy independence of central banks in the name of rescuing the monetary policy from any inflationary bias often lands in a treacherous terrain of autonomy synonymous with

autocracy (Rymes, 1995-1996, p. 178). As a sequel, monetary authorities adopt analytical positions which are quite unintended yet motivated by 'theoretical predilections' an euphemism for ideological inclinations. The posturing often results in parading subjective viewpoints as though empirical findings without appraising the situation in an exhaustive manner reminds of an exercise of opinion building which is awfully unseasonable in a headline annual report. However, the implications are profound as these delicate bids venture into the landscapes that are under the exclusive domain of popular governments.

References

1. Alesina, A., & Gatti, R. (1995). Independent Central Banks: Low Inflation at No Cost? *The American Economic Review, 85*(2).
2. Alesina, A., & Summers, L. (1993). Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence. *Journal of Money, Credit and Banking, 25*(2), 151-162.
3. Blinder, A. S. (1982). Core Inflation by Otto Eckstein. *Journal of Political Economy*, 1306-1309.
4. Carvalho, F. J. (1995-1996). The Independence of Central Banks: A Critical Assessment of the Arguments. *Journal of Post Keynesian Economics, 18*(2), 159-175.
5. Cukierman, A. (1992). *Central bank strategy, credibility, and independence.* Cambridge, MA: MIT Press.
6. Das , A., John, J., & Singh, S. (2009). Measuring Core Inflation in India. *Indian Economic Review*, 247-273.
7. Eckstein, O. (1981). *Core Inflation.* Prentice-Hall, New York.

8. Freire, P. (2005). *Pedagogy of the Opressed.* The Continuum International Publishing Group Inc, Newyork.

9. GoI. (2014). *Economic Survey 2013-14.* New Delhi: Govt of India.

10. Keynes, J. M. (1936). *The General Theory of Employment, Interest and Money.* Harvest/HBJ, Florida.

11. Levy, D. A. (1995-1996). Does an Independent Central Bank Violate Democracy? *Journal of Post Keynesian Economics, 18*(2), 189-210.

12. Mohanty, D., Rath , D. P., & Ramaiah, M. (2000). Measures of Core Inflation for India. *Economic and Political Weekly*, 273-282.

13. RBI. (2014). *Reserve Bank of India Annual Report 2013-14.* New Delhi: RBI.

14. Rogoff, K. (1985). The Optimal Degree of Commitment to an Intermediate Monetary Target. *Quarterly Journal of Economics, 100*(4), 1169-90.

15. Rymes, T. K. (1995-1996). Autonomous and Accountable. *Journal of Post Keynesian Economics, 18*(2), 177-187.

16. Sargent, T., & Wallace, N. (1981). Some Unpleasant Monetarist Arithmetic. *Federal Reserve Bank of Minneapolis Quarterly Review, 5*(3), 1-17.

17. Times of India. (2014, July 12). *SC orders govt to pay new NREGA wages.* Retrieved December 06, 2014, from Times of India: http://timesofindia.indiatimes.com/india/SC-orders-govt-to-pay-new-NREGA-wages/articleshow/38227198.cms

Rethinking the Role of Monetary Policy in India: A Critical Analysis

5

B. Pradeep Kumar

I. Introduction

The ever increasing attention being paid to finance capital and the financialization[1] process itself has rendered the old fashioned monetary policy apparently in effective in accomplishing celebrated twin objectives of containing inflation and fueling economic growth. It is becoming evident that the growth of financial institutions which have not been directly regulated by the Central Banks as in the case of orthodox financial intermediaries, has in fact rendered the weapons of monetary policy almost inoperative, and therefore, it appears that central banks all over the world, especially in developing countries like India, have confined themselves into the role of 'measuring' inflation and taking steps to ease inflationary pressured by the way of putting certain 'classical restrains' on the lending rate of formal financial institutions over which Central Banks still have the regulatory mandates. To validate this, for instance, let us recall the euphoria that were created in the air by the present incumbent at the RBI, Dr.Reghuram Rajan[2], when he wore the suite of RBI Governor quitting his assignments at the IMF, that he

would appoint Committees after committees to look into domains of present monetary policy framework, and adopt policies triggering economic growth. The expectation was that he would deviate from the 'mistakes' which his predecessors had made, and introduce policies that would help the economy to take a new route of growth by way of reducing the cost of money, and thereby encouraging the real sector to invest, and create more gainful employment opportunities. But two years down the line, Reghuram Rajan's tall promises still remain unfulfilled, and it is astonishing that he seems to have put his feet in the same shoes of his predecessors; increasing regulatory rate of interest point wise claiming that inflation would have to be tamed. Thus it is obvious that Central Banks in most of the developing economies especially in countries like India have become the mere institutional arrangements to manage currency issues so that inflation is not accelerated to derail the system, heeding nothing to the growth and development imperatives of the country. In the background of these developments, the present work intends to examine the contours of monetary policy in India and while examining the turnaround in monetary policy the paper also attempts to look into whether the policies have given effect to the real economic intentions of the government viz. augmenting employment, income and stabilizing the price level, and to suggest ways of adapting monetary policy to the real economic requirements of the country.

II. What is Expected of MP Theoretically?

Before dwelling into the various aspects of present monetary policy in India, it is important to have a theoretical insight into the significance of monetary policy as a macroeconomic

tool[3]. It has been well understood that Inflation is always a monetary phenomenon at least in developed nations (Friendman, 1956). Now, theoretically speaking, MP forms an important arm of economic policies of any type of government. The strength, spirit and the relevance of MP actually emanates from the undisputable role that money plays in an exchange economy. Every economy is compartmentalized into: the real sector and the monetary sector. A decoupling of these two vital segments of an exchange economy eventually collapses the system, and that is why, taking note of this, many well established economists have called for the proper and effective integration of the real and the monetary sector. The Classical writers, while believing in full employments, found monetary policy as neutral in its influence on real variables, and argued that changes in the stock of money could only decide the direction of the general price level leaving real variables unaffected. Contrary to this view, Keynesian on the other hand stood with the argument that such neutrality of money becomes operational only once the economy is put into the situation of full employment, and so long as the country is ravaged under the problem of unemployment of productive resources, monetary policy could be used to impact real economic variables viz. output and employment. For long, the entire discussion on the role of monetary policy in influencing real economic variables has centered on these two paradigms which are poles apart in their approaches.

In this context, it is quite imperative to look into the expected role of monetary policy in countries like India which has been saddened with the problem of unemployment and poverty for a long period of time. In India too official appointees

of Central Banks have always had the view that taming inflation within the affordable limit ought to be the primary objective of monetary policy although governments especially finance ministers have always been demanding monetary policy to be pro active in tackling real economic issues. Such has been the gravest and perhaps the toughest stand the highest officers of Central Banks used to take that in some occasions even the governors of RBI expressed their willingness to step down from the post of Governor if Central Government continued the policy of pressuring them to fall in line with dictates of Central Government as far as the monetary policy is concerned[4].

What might have pursued Central Bank to curiously and vigorously focus on controlling money stock to stabilize the price level without heeding to the real economic requirements of the nation? One reason, perhaps, had been the influence of foreign exchange reserves on the high powered money stock of our country. During the regulated regime of the forex market, there could be compelling circumstances when the fluctuations in the forex reserves owing to volatile Balance of Payments (BoP) exerted unwelcoming pressures on the reserve money stock of the country. To counter this, like any central bank of countries running a regulated exchange rate and a market, the RBI as well would have to resort to 'sterilization' techniques to free the domestic money supply of external disturbances. Barring this technically undeniable factor, another factor that might have been at work is the perpetual policy of Government to run fiscal deficit and its repercussions on the money supply of the country which needs to be looked into in detail.

III. The Villainous Role of Budget and the Entry of Monetary Targeting

Having said all that Central Bank should look beyond merely monitoring the rate of growth of money supply in a country like India, one must be contended with the fact that uncontrolled monetary expansion in the pursuit of rejuvenating the real sector by injecting liquidity may create and exacerbate severe instabilities in the monetary system, resulting in the eventual derailment of the economy. We have experiences of countries facing complete inexplicable financial anarchy like Iraq where people used to move to market with basket of money only to return home with pocket of goods when galloping inflation crept into that nation following the invasion of US led western troops. Even now, before us, there is the Sudan money market, where money has eventually become just papers devoid of commensurate value. Undoubtedly, one cannot expect such things to happen in a developing country like India.

Knowing these things that once things get out of control it is difficult to bring back financial normalcy, Central Bank in India has been very cautious in dealing with issues pertaining to money supply. But certain factors external to Central Bank like the fiscal deficit that creeps into the budget of the central government has appeared to be an influencing determinant of money supply in India. Several steps to reduce fiscal deficit aside, still the problem persists unabated thanks to the failure on the part of the central government to mobilize revenue both direct and indirect, and to axe the unproductive expenditure of the government. The fiscal deficit unless bridged by the government borrowing would lead to minting additional

currency, that is increasing the High Powered Money (Gupta, 2010), and when it is put to the system, multiplied via credit creation process, would further trigger of growth in broad measure of money supply, which is labeled as M^{35}. In fact this fear had ruled the monetary policy makers in India for quite some time, and of course, one cannot find fault with them in assessing the impact of high fiscal deficit in that way. It was with the intention of diluting the pressure of fiscal agencies on the determination of money supply in India that a committee headed by Prof. Sukhmoy Chakravarty, later came to be known as the Chakravarty Committee, was appointed to look into all gimmicks of this unholy tie up between the fiscal deficit and high powered money growth. This committee, after having gone into the details of this mechanism, had made a historic recommendation in the monetary history of the country that a target rate of growth of money expansion needed to be set up after consultation between the RBI and the GOI which would bind both organizations in a common effort of containing the rate of growth of money supply in India. This entire process of fixing the target rate of growth of M_3 has later come to be known as the 'Monetary Targeting' (MT, hereafter). To put in other words, the MT was one of the first step to free the Central Bank and the money supply from the unnecessary exertion of the fiscal deficit, or it could be well said that MT broke the connection between the fiscal deficit and the money supply partially putting an end to the coercion that GOI could place on the RBI.

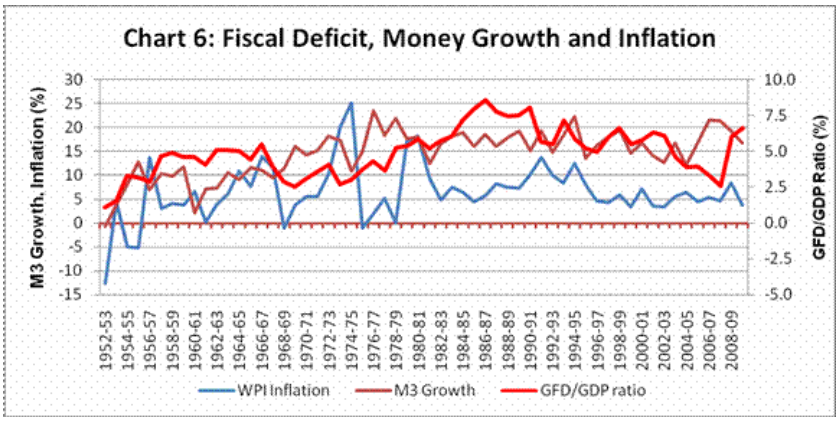
Had excess money supply due to high but manageable fiscal deficit been problematic for the Indian economy? Well,

an answer to this question requires much analytical exercise. But viewing from straightforward commonsensical stand, the plain picture before us might compel us to argue that during the time till the MT came to the picture at least, the money supply had not put any pressure on India's growth and development. During this testing time in the post independent India, she had made path breaking accomplishments building many temples of heavy industrialization, the benefits of which we are reaping today. Although growth had not been that much crazy during this period, development did take place which undoubtedly drove the economy to high growth path in the later period including the post liberalization period. It needs to be noted here that during this period, the impact on price level could be absorbed to a greater extent without badly affecting the real income of the people.

Several studies analyze the nexus between deficit and inflation. The course of nexus can be of two types: Deficit induced inflation and Inflation induced deficit (Rangarajan & Mohanty, 1998). Boost in money growth may be the outcome of high fiscal deficit. On the other hand, the existence of high inflation could also lead to high fiscal deficit thanks to the high cost economy. Generally it has been documented that high fiscal deficit is detrimental to the economic growth. This is primarily due to the fact that fiscal deficit is financed by money supply creation having untoward effect on the growth prospects of the economy in future. But if fiscal deficit is the result of investment by the government on productive sectors, in the long run, through supply side effect, fiscal deficit can turn out to be a blessing for the nation. However, it needs to be noted

that fiscal deficit in pre-reform period did not reduce GDP as much as it happened in the post-reform period. For instance, a study obvious shows that one percent increase in FD reduced GDP by .41 percent in the reform period of 1992-2011 whereas it did reduce GDP only .014 percent in the pre-reform period 1970-1991 (Monhanty, 2014). Moving further data reveal that fiscal deficit, measured as GFD/GDP ratio and WPI inflation, have not exhibited any noticeable relation in India both in the reform and pre-reform period, whereas fiscal deficit and money growth have (Figure No.2).

Figure 2 Fiscal Deficits, Money Growth and Inflation



Source: RBI publications

IV. The External Effect and BOP Crisis

One bad consequence of persistent fiscal deficit and its repercussions on the quantum of domestic money supply was felt on the external part of the economy in the form of spiraling prices of exports, making India's trade competitiveness poor relative to other similar nations. The escalating import bill coupled with plummeting export earnings wiped out India's

foreign exchange reserves which worsened the BOP position. This severe BOP crisis was the impending reason which forced the country to knock the doors of IMF and World Bank for conditional or tied aids. Following the prescriptions of these donor institutions at the behest of the US led group, India had to abide by the policy of keeping fiscal deficit low, and FRBM[6] act had to be passed to make low fiscal deficit mandatory. Thanks to all these steps, today Central Bank of the country has been in a safe position as it has been relieved of the pressures of GOI's fiscal deficit in determining the quantum of H[vii] money to be issued. This in fact has become a blessing in disguise for the RBI as there has been voice in the air in favor of allowing autonomy for the RBI. The relief from GOI fiscal deficit at least partially can be reckoned as a practical step towards the autonomy of the CB.

Now, we have a CB free of policy intervention from the part of GOI to a greater extent; a CB to decide only on the money supply growth. The question now is: Does CB appears to be so essential to decide only the cost of money, and thereby taking decision pertaining to the rate of growth of money supply. The way of functioning of CB for quite some time tempt not to disbelief that CB has deviated from its objective of accomplishing certain growth parameters. A cut in interest rate can do wonders unless liquidity trap operates and the operation of liquidity trap itself is a remote possibility. But, our CB has been reluctant to run a cut in policy interest rate so as to give a right signal to the real sector to boost its investment. The seemingly unjustifiable reluctance on the part of the CB in executing a slash in policy interest rates so as to rejuvenate the real sector has cost the economy a lot.

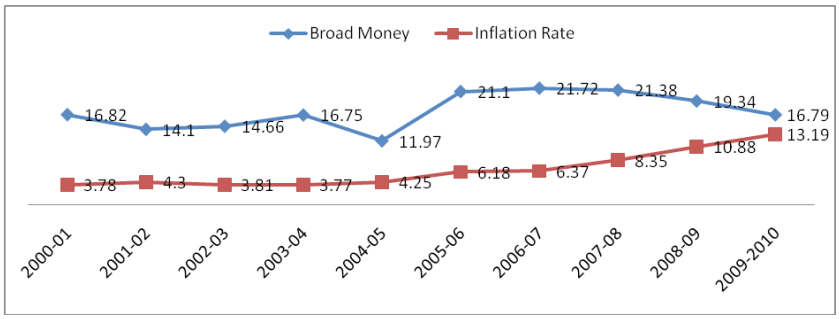
As a corollary to this, one must understand the fact that in India inflation has unequivocally been regarded as a structural catastrophe rather than a demand induced one. Despite many studies stressing the structural nature of inflation, the policy makers have been giving deaf ear to this, and they appear to have been treating inflation as demand side problem and suggesting much tried out monetary solutions. Theoretically, inflation is demand side tragedy in so called full employed western countries, whereas in countries like India it continues to be supply side, more emphatically, a structural one. Hence, it is not understandable why RBI has been stressing more on controlling liquidity in the name of taming inflation without facilitating the implementation of strategies (using longsighted supply side solutions) to arrest inflation.

V. The MSP Role in Inflation

Studies have shown that inflation in India has hardly been influenced by the CB's policy variables; rather, it has well been proved through econometric models that inflation has been set and reset in accordance with the announcement of Minimum Support Price (MSP) which is of course has been a political maneuvering in a country like India. Obviously, it has been revealed that changes in MSP is key to explain around 5 percent variance in CPI inflation in India, and perhaps on account of this that inflation in India has sarcastically been called MSP inflation (Bhalla, 2014). That is inflation of today could be explained by the MSP announced in the previous year, which underlines the much held position that inflation in India has been a structural one, or more obviously, a politically motivated thing. Moving further it is obvious that inflation in India has

not been much caused by changes in money supply. Most interesting thing is that such a trend is visible in the reform period too. A glance at the figure provided below stands testimony to this (Figure No.2).

Figure 2 Broad Money and Inflation Rate



Source: RBI publications

VI. Concluding Observations

The foregoing discussion on the monetary policy of the RBI in the context of the macroeconomic environment clearly emphasizes the need to reorient the monetary policy to materialize the real economic objectives of the country. The time has ripened enough to change the course of action of RBI with regard to the implementation of monetary policy tools. What the regulator requires is a package of policies in line with the strategies of government to take the economy to a new track of growth. Short term monetary tools can no longer be considered as a permanent solution to address the problem of inflation. What we really require is supply side adjustments smoothed by monetary policy support. Money should oil the system, stimulate the economy, and finally it should stabilize the economy as well. Since the Indian economy has been

witnessing the emergence of specialized banking and non-banking financial intermediaries, the role of RBI itself has become more complicated. It calls for segregating the role of RBI as a regulator from that of the custodian of monetary policy tools.

End Notes

i. Financialization connotes a situation where social relations are increasingly expressed in terms of money. Or in other words a situation where every exchange is made with the medium of financial device.

ii. Mr. Rajan, who assumed office of the Governor of RBI amidst the crisis increased the repo rate by 25 basis points or 25 percent to 7.50 percent surprising the business community in India.

iii. However, we do not intend to give a complete theoretical outline of the monetary policy which any standard book on monetary economics would do.

iv. I G Patel in his book on his role as an economist in various positions referred to such occasions.

v. M3 is considered as the broad measure of money supply in India which inter alia comprises of currency, demand liabilities, fixed liabilities and post office savings.

vi. FRBM stands for Fiscal Responsibility and Budget Management Act, a legislative initiative to bring in fiscal discipline, and thereby to reduce fiscal deficit.

vii. H money refers to High Powered Money which is acting as the monetary base.

References

1. Bhalla, S. (2014, September 13). Where Monetary Policy is Irrelevant? *The Indian Express* .
2. Friendman, M. (1956). *The Quantity Theory of Money.*
3. Gupta, S. B. (2010). *Monetary Economics: Theory and Policies.* New Delhi: Sultan Chand.
4. Monhanty, R. K. (2014). *Fiscal Deficit-Economic Growth Nexus in India: A Cointegration analysis*. Retrieved November 27, 2014, from www.punjabiuniversity.ac.in.
5. Rangarajan, C., & Mohanty, M. S. (1998). Fiscal deficit, external balance and monetary growth. *Reserve Bank of India Occasional Papers* , 635-653.

China's Currency Ambitions and the Fading Brettonwoods Institutions

6

Tojo Jose

I. Introduction

The evolving world economic order is in the process of accommodating the rising economic clout of China. All leading trends and forecasts indicate that China's ascend to the top position edging out the US, will be much quicker than previously expected.

Developments in the post- crisis period gives ample proof that China is navigating arrangements and agreements on a strong foot to achieve the various externalities related with its rise in the global economy. A major objective of Beijing on this front is to make renminbi a global reserve currency. Over the last few years, Chinese political leadership and policy makers were openly criticizing the dollar hegemony. Former President Hu Jintao has described the present international monetary system characterized by Dollar supremacy as a 'product of the past.'

Frequently, China is demanding the restructuring of the SDR's (Special Drawing Rights, which is the reserve currency of IMF) currency basket base. Broad basing of the SDR currency basket is an important part of China's IMF reform package. Here, Beijing's intention is to include renminbi as a reserve currency in the SDR's reserve basket.

II. Exorbitant Privilege

Recently, a number of countries including reserve currency aspirants as well as sovereign investors in US government securities are raising concerns about the Dollar's international status. The dollar's supremacy and the plausible gains accrued to it did not remain historically unnoticed. Former French Finance Minister Valery Giscard d' Estaing has observed that the US continues to enjoy an 'exorbitant privilege' because of the reserve currency status of the Dollar.

Giscard's view about the US's privilege as the supplier of the world's most sought reserve currency has supported by events in recent years. The US is the largest debtor of the world and it has the largest trade deficit in absolute terms. But still in the last five year or so, it is coming out of this economic catastrophe without being hurt, mainly because of the reserve currency position of the Dollar. Central banks and government affiliated institutions are investing their dollar earnings in US treasury bills and thus the American government was able to finance its historically high deficits out of foreign borrowing. Another perplexing angle of the privilege is that over the last few years, the world is witnessing a strange phenomenon of weakening of the US economy and strengthening of Dollar's reserve currency status.

Indeed, the US is enjoying an exorbitant privilege despite losing its economic sheen. Understandably, brilliant performers like China are annoyed of this. At the same time, major reserve holders having made big investment in Dollar denominated US treasury bills doubts about the Dollar's supremacy

unsupported by the performance of its economy. Migration to non-dollar denominated sovereign assets is a matter of wise decision for them to make the value of foreign exchange reserve safe. Here lies the opportunity of China to develop the renminbi as an international currency.

So China need not prepare a coup to bring the dollar down. Interestingly, Beijing is not sitting passive. It is co-working with like-minded people who have doubts about the continuation of the Dollar hegemony. In the last few years, China is using various international forums and bilateral agreements to augment the internationalization of renminbi.

A search into economic history reveals that internationalization of a currency and acquisition of reserve currency status is a long term process. For example, the US became the largest economy in 1870, but its currency got international status only by 1925. At a closer look, it seems that the Dollar travelled many distance from 1914, when the currency was nowhere near to a hard currency; to an international currency in 1925. The process was much quicker because of the weakening of the British economy at the impact of the First World War. The fall of sterling and the rise of dollar have coincided with the weakening of the British economy and ascend of the US economy. But it has been quickened by the destructive effect of the war on the British economy.

A similar situation is not there in 'the new battle in the new century' where the renminbi is pitted against the dollar. Here, China has to make various promotional measures for its currency. First is internationalization; which means denominating

and settling cross border trade and financial transactions in renminbi. Second are capital account convertibility measures to facilitate inflow and outflow of capital. Third, other central banks should hold renminbi as a protection against balance of payment crisis. An excavation on recent issues reveals that China is tailoring and implementing programmes on all these fronts to quicken the reserve currency status of renminbi.

III. Internationalization of Renminbi

Despite rising trade share, the role of renminbi as a reserve currency remains disproportionately small. At present, trade settlement in renminbi is a meager 0.2% of the total world trade. Researchers on the topic project that renminbi should go a long way to get the status of a reserve currency.

Raising the status of renminbi to a reserve currency is one of the strategic ambitions of Beijing. Often they have expressed this intention in quite vocal manner itself. But the notable part of their currency policy is that over the last five years China has developed a clear plan and implementing it with clinical precision. Chinese efforts for the internationalization of renminbi are done through different modes. Firstly, Beijing is signing bilateral agreements for using domestic currency for trade settlement. The purpose here is to compel trade partners to use renminbi rather than dollar. Local currency trade settlement agreements were reached between China and its major trading partners including Russia and Japan. Such agreements will lead to less dependence on Dollar for conducting trade at the same time promoting the use of renminbi.

The internationalization of renminbi using the trade channel is a rewarding strategy as China is emerging as the largest trading country. If Beijing is able to settle bilateral trade transactions with non-reserve currency countries in renminbi, it means that nearly half of Chinese trade will be settled in renminbi in the immediate future. Since the trade share of China is expanding rapidly, local currency trade settlement would be the most rewarding way to internationalize its currency.

The second channel for internationalization of renminbi is to open up the Chinese financial market. Capital account convertibility with opening up of the credit, equity and bond market is a necessary prerequisite to enhance demand for renminbi. For this, China has recently allowed its government securities market to other central banks and government owned institutions. Japan has already purchased US $10.3 billion worth of Chinese government bonds. Other countries including Malaysia, Austria, Indonesia etc have also bought Chinese bonds.

For foreign central banks, opening of Chinese bonds market is an additional safe investment opportunity. The advantage is that they can now spread their investment to a wider range of assets instead of concentrating it on Dollar denominated US treasury bills. If China is liberalizing its bond market at a quicker pace, major reserve holding central banks in the immediate future may reallocate their holding in favour of Chinese government securities away from the US securities.

On the third channel, Beijing is campaigning for the governance reform at the IMF, expecting that it may facilitate status quo of renminbi as a reserve currency. In major economic

forums, Beijing's demand is to make the international monetary system more 'broad based'. The implied demand here is to make renminbi as a reserve currency of the SDR's currency basket.

IV. China's Currency Ambitions and the BRICS

From its first summit at Yekaterinburg to the last summit at Fortaleza, the BRICS is very vocal in raising objections against the shortcomings of the west dominated international financial architecture.

The BRICS has concern over the governance as well as the performance of the Breton woods institutions. Similarly, it holds the view that the west is busy in designing the bailout type transient mechanisms and adjustments to the existing institutions to heal their financial disorders. These disorders were largely the outcomes of their weak regulations of financial systems and innovations which had little social value. So, a client based governance of international financial institutions is needed to give priority to the development issues of the south.

The BRICS's main purpose is to claim a due share for its members in the international monetary system. Here, it is natural that as China is the most powerful country in the emerging world, the organization's demand for bigger role effectively becomes a bigger role for China. So far this has happened in the working of the BRICS; evidence of which can be seen by examining the decisions reached at in its various meetings. The Chinese efforts to enhance the internationalization of renminbi and the demand for a fair role in the reserve currency system of the IMF were important part of the declarations at various BRICS summits.

Beijing has used the BRICS platform to promote the renminbi through different ways. Firstly, within BRICS, agreements for settling trade in domestic currencies were reached with Russia and a currency swap agreement was signed with Brazil. Secondly, to encourage the use of its currency, renminbi denominated lending within the organization was launched. Thirdly, China was successful in inducting the demand for reforming the international monetary system by making a broad based currency reserve system at various BRICS summit declarations.

In the Yekaterinburg summit, the main resolution ratified demanded for a more diversified international monetary system. Even though it is not elaborated, what is implied here is the diversification of the SDR basket of reserve currencies by including the national currencies of the BRICS members. Certainly, it is an indirect proclamation of the renminbi's candidature.

At Brasilia, the summit declaration aired a more radical Chinese voice by urging the members to make local currency trade settlements.

The Sanya summit which China hosted in 2011 witnessed a complete takeover of Chinese currency campaign in the summit declaration, though other issues also got their usual place. For the first time, the BRICS declaration demanded a more broad based currency reserve system. More specifically the declaration said that "We welcome the current discussion about the role of the SDR in the existing international monetary system including the composition of SDR's basket of

currencies." Here, the Chinese demand for the inclusion of renminbi in the SDR's basket of currencies has got an important place.

The Sanya declaration has implicitly contained intra-BRICS arrangements for the internationalization of renminbi. The meeting decided 'to gradually increase mutual credit lines denominated in national currencies and to settle transactions in national currencies in order to promote mutual trade and investment.' Renminbi denominated lending was an additional step to promote Beijing's currency aspirations and China Development Bank played an active role in Intra BRICS lending under BRICS Inter-bank Cooperation Mechanism.

The New Delhi summit has shown the depth of divergence of interests within the BRICS. The summit declaration was silent on currency based reform of the international monetary system. It only urged for a representative international financial architecture by accommodating the voice of the developing world. Similarly, there was no mention about local currency trade settlement which found a place in Brasilia and Sanya. The only specification which seemingly supported the renminbi promotion was the Master Agreement on Extending Credit Facility in Local Currency. The Master Agreement enables China to give renminbi denominated lending and thus to help the internationalization of its currency.

At Durban, the Chinese renminbi ambitions made a strong come back. The summit declared that "We support the reform and improvement of the international monetary system, with a broad-based international reserve currency system... We

welcome the discussion about the role of SDR in the existing international monetary system including the composition of SDR's basket of currencies." Thus, the Durban summit completely reflected the Chinese currency ambitions. An important development at Durban was that at the meeting, China and Brazil have reached a currency swap deal.

The Fortaleza decisions are well supportive of the Chinese ambitions. BRICS's decision to establish a development bank is the first credible challenge to the Bretton woods institutions. Given that the headquarters of the proposed bank will be at Shanghai, the development indicates that the world is now going to see a Chinese Bretton woods.

So far, Beijing's self interest in BRICS figures mainly in the form of its currency ambitions. But the ability of BRICS to collectively force a new world economic order is doubtful, even after the establishment of the development bank. Looking from inside, the organisation was visibly divided and tensed because of the overweight of China till Fortaleza. Now, the setting up of the BRICS bank indicates that other members in the organization seem to have adjusted with Chinese overweight. If BRICS is the first platform for China to enforce its currency ambition, it has won the first round of the match.

References

1. Prasad S Eswar (2014): The Dollar Trap, Princeton University Press ISBN 9780691161129
2. Barry Eichengreen (2011), Exorbitant Previlege, Oxford University Press, ISBN: 9780199753789
3. Yekaterinburg BRIC Declaration, www.brics.utoronto.ca/docs/
4. Brazilia BRICS Declaration, www.**brics**5.co.za/about-**brics**/**summit**-**declaration**/**second**-**summit**/
5. Sanya BRICS Declaration, www.**brics**.utoronto.ca/docs/
6. New Delhi BRICS Declaration, http://www.cfr.org/brazil/brics-summit-delhi-declaration/p27805
7. Durban BRICS Declaration, www.**brics**.utoronto.ca/docs/
8. Fortaleza BRICS Declaration, **brics**6.itamaraty.gov.br/.../214

Major Impacts of Global Economic Crisis on Indian Economy

7

M.P. Abraham and Shijo Philip

Abstract

The global financial crisis started showing its effects from mid 2008. The economic failure of large investment banks as well as commercial banks in nations around the world in the mid 2008 added fuel to the global economic downturn. Many industrialized nations like US, UK, Germany have slid into recession. The crisis produced a wide-ranging impact across the globe including deceleration of growth; economic slowdown; contraction in world trade and reduced access to trade finance; negative effects on trade balances and balance of payments; dwindling levels of FDI; massive reversal of private capital flows; severe damage to the housing market, the banking sector and financial sector as a whole; and reduced public confidence in financial institutions. The Indian economy was relatively less affected by the global crisis. While the developed world plunged into recession, the Indian economy was affected by the "spill-over effects" of the global financial crisis. The crisis generated a shock in Indian economy particularly its external sector, but it was not catastrophic because of the special circumstances in India. Trade diversification both in terms of commodities/ services and the regional direction shifting from traditional US and Europe to emerging markets including China and Latin America served to insulate India from global shocks emanating from the advanced countries. More over India's recent growth was driven predominantly by domestic consumption and investment.

I. Introduction

The global economic crisis of 2007-08 had many similarities to those of the past. The events of this crisis had echoes in earlier big international financial crises of 1857, 1893, 1907 and 1929-33. The crisis started with the collapse of the subprime mortgage markets in the U.S. in early 2007 and the end of a major housing boom.

The Indian economy looked to be relatively insulated from the global financial crisis that started in August 2007. The Indian Economic Performance during global economic meltdown demonstrated the basic soundness and growth potential of the Indian economy. The global financial crisis started showing its effects from mid 2008. The economic failure of large investment banks as well as commercial banks in nations around the world in the mid 2008 added fuel to the global economic downturn. Many industrialized nations like US, UK, Germany etc. slid into recession.

The crisis produced a wide-ranging impact across the globe like deceleration of growth; economic slowdown; contraction in world trade and reduced access to trade finance; negative effects on trade balances and balance of payments; dwindling levels of FDI; massive reversal of private capital flows; severe damage to the housing market, the banking sector and financial sector as a whole; and reduced public confidence in financial institutions.

II. Major Causes of the Crisis

First, the US and some other European countries enjoyed *prolonged boom in house prices* since the early 1990s right up to

end of 2006. People began to believe that house prices would only go up; they would never fall. This led to massive amounts of lending by banks for home purchases, often to borrowers who did not have jobs or steady incomes. In other words, many of these borrowers were "sub-prime" or simply not credit worthy. Later, the financial institutions repackaged the sub-prime debts into financial instruments called *Collateralized Debt Obligations (CDO)* and sold them to investors world-wide. In this way the risk was passed multifold through derivatives trade.

This housing bubble was part of a massive *borrowing binge in the US and some European countries* by households and financial institutions that was fuelled by the "easy money" policies of their central banks and huge inflow of funds from capital surplus countries such as China, Japan, Germany and oil exporters. These big exporting nations sold their products to American and European consumers and then parked their surpluses (over and above their imports) in American and European government securities. Consequently the ratio of gross debt to GDP of US and European governments more than doubled.

The huge increase in borrowing was encouraged by *rapid financial innovation* which reduced and transferred the risk of default by sub-prime home loan borrowers. The explosion of financial innovation fuelled excess growth of the finance industry and built an enormous house of financial cards on a weak base and this could go on for many years because of *a growing culture of weak regulation of financial institutions* and markets in the US and Europe for the past few decades.

III. Sequence of the Crisis

In the winter 2006/7 housing prices started to fall for the first time. As a result many of the subprime housing loans (mortgages as they are called) became bad loans and hundreds of billions of dollars of financial derivatives which were based on these underlying mortgage loans lost their value. Thus, by the summer of 2007, a number of American and European banks announced huge losses on their mortgage related securities and investments.

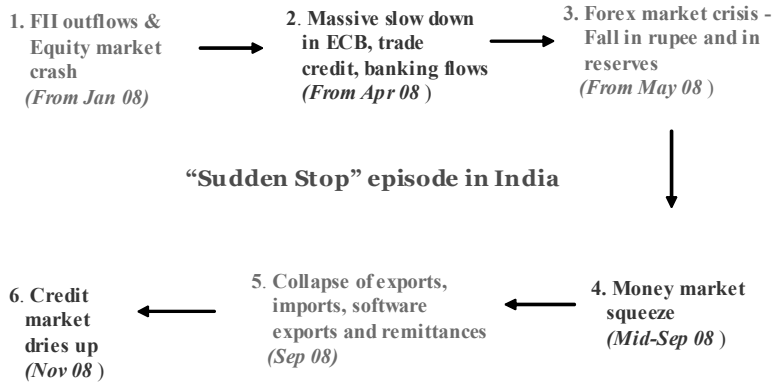
This process of financial collapse became severe in September2008 when major American investment banks (like Lehman Brothers) collapsed and others (such as Merrill Lynch) were saved through forced mergers with healthier banks.

The financial melt-down of September 2008 led to a freeze of credit markets in the US and Europe and transmitted the sudden liquidity squeeze throughout the financial world. The sharp slowdown in economic activity in the US and Europe quickly spread across the world through the channels of a global credit squeeze and a massive drop in demand for goods and services from major exporting nations like China, Japan, Germany and several other Asian countries including India. In this way the financial crisis in the US and parts of Europe not only damaged production and growth in these countries but led to sharp drops in exports, production, consumer spending, and trade of the countries depending on the US and European markets. The present US economy is 20% of the world economy and during the time of Great Depression, it was only 3%.

IV. Spread of the Crisis to India

The spread of the crisis to India can be better understood within the framework of the 'sudden stop' analysis. The concept of "sudden stop" was first introduced by Dornbusch (1995) and later given analytical framework by Calvo (1998) to examine the impact of a sudden and largely unexpected cut-back in foreign capital inflows to emerging economies. It states that "it's not speed that kills, it's the sudden stop". The chart below depicts the various stages in the process of the spread of the global financial crisis to India within the framework of the "sudden stop" analysis.

The Spread of Crisis to India



The first impact of the global crisis on India was felt in stock market in January 2008. This came through the reversal of inflows from foreign institutional investors (FIIs) into the country. The FIIs withdrew funds from all over the emerging markets for meeting the liquidity requirements of their principals in the US. The sudden withdrawal of FIIs from the

Indian stock market brought about a crash in the market in January 2008.

In stage 2, we see sharp drop in inflows and then huge return flow of capital under external commercial borrowings, short-term trade credit and external borrowing by banks from April 2008. There was a huge return flow of capital from India in the second half of the year with regard to short-term trade finance and bank borrowings to the extent of US$ 9.5 billion and US$ 11.4 billion respectively.

The crisis then moved to the foreign exchange market (Stage 3). The rupee began to fall from end-April 2008 to November 2008 by about 20 per cent. The Reserve Bank of India intervened by selling dollars to smoothen the fall of the rupee. The heavy selling led to a massive depletion of the stock of reserves from US$ 315 billion in May 2008 to US$ 246 billion in November 2008.

By mid-September 2008, the crisis gripped India's money market (Stage 4). The drying up of funds in the foreign credit markets led to a virtual cessation of external commercial borrowing for India including the access to short-term trade finance. The collapse of stock market ruled out the possibility of companies raising funds from the domestic stock market. Indian banks also lost access to funds from abroad and all these led to a liquidity crisis.

The current account of India's balance of payments had shown strong growth in the first half of 2008-09 and after that we see a collapse of exports, imports, software exports and remittances. Thus the impact of the global crisis manifested

itself in the real sector through the collapse of India's trade sector (Stage 5).

In the next stage (Stage 6), the crisis spread to the domestic credit markets. Expansion of bank finance to the commercial sector slumped. Banks became extremely risk averse with the perception of considerable default rising.

V. Implications for India

Contrary to the 'decoupling theory', emerging economies were hit by the crisis. The decoupling theory held that even if advanced economies went into a downturn, emerging economies would remain unaffected because of their substantial foreign exchange reserves, improved policy framework, robust corporate balance sheets and relatively healthy banking sector. The contagion of the crisis, however, spread to India through all the channels – the financial channel, the real channel, and the confidence channel. However, the sovereign debt crisis in U.S. and Europe did not have much impact on the Indian economy.

Insofar as financial channel is concerned, India's financial markets - equity markets, money markets, for-ex markets and credit markets - all came under pressure from a number of directions. First, as a consequence of the global liquidity squeeze, Indian banks and corporates found their overseas financing drying up. Second, the for-ex market came under pressure because of the reversal of capital flows. Both these factors put downward pressure on the rupee.

Insofar as the real channel is concerned, the transmission of global crisis to the domestic economy was through a slump in global demand for goods and services. The United States,

European Union and the Middle East, which accounted for three quarters of India's goods and services trade, were severely hit by the crisis. Remittances from migrant workers also declined.

The crisis also spread through the confidence channel. The tightened global liquidity situation in the period, immediately following the Lehman failure in mid-September 2008, increased the risk aversion of the financial system and made banks cautious about lending.

VI. Impact on Growth

In 2008-09, following the global meltdown, the growth rate of the Indian economy dropped to 6.7% from an average growth of 8.8% in the preceding five years. It is worth noting that India's GDP growth in 2008-09, however, was one of the highest in the world. This reflected the resilience of the country's growth impulses to a severe external shock. It is clear from the table shown below.

Among the three sectors, the impact of global crisis was severe in the Secondary sector. Manufacturing and construction were, however, severely affected by the crisis. The industrial sector experienced a recession during the year 2008-09.

During 2008- 09 the growth in private consumption demand decreased to 2.9% from8.5% in 2007-08. Coupled with a decrease in the investment demand this was a major blow for the economy. The last quarter of 2008-09 and the first quarter of 2009-10 witnessed slight recovery from the downturn. Thus, the Indian economy performed remarkably well, despite the global economic crisis.

Table 1

Rate of Growth at factor cost at 2004-05 prices (per cent)

Sectors	Pre Meltdown Years		Pre Meltdown Years	
	2006-07	2007-08	2008-09	2009-10
1.Agriculture, Forestry & Fishing	3.7	4.7	1.6	-0.2
2.Mining & Quarrying	8.7	3.9	1.6	8.7
3.Manufacturing	14.9	10.3	3.2	8.9
4.Electricity, Gas & Water Supply	8.5	10.0	3.9	8.2
5.Trade, Hotels & Restaurants	11.2	9.5	5.3	8.3
6.Construction	10.6	10.0	5.9	6.5
7.Transport, Storage & Communication	12.6	13.0	11.6	-
8.Finance,Insurance,Real Estate & Business Services	14.5	13.2	10.1	9.9
9.Community, Personal & Social Services	2.6	6.7	13.9	8.2
Total GDP from all sectors (factor cost)	**9.7**	**9.2**	**6.7**	**7.2**

VII. Impact on External Sector

The overall effect of the global economic crisis on country's external sector can be well analysed through the Balance of Payments position of the economy. The Balance of Payment comprises current account, capital account and changes in foreign exchange reserves.

1) Status of Current Account of Balance of Payment

Under current account of the Balance of Payment, transactions are classified into merchandise (exports and imports) and invisibles.

Despite impressive growth figures, the performance of external sector was poor. Till the advent of the crisis, Indian merchandise trade had shown robust growth. India's merchandise exports (in US $) grew at rates between 22 to 31% over 2004-05 to 2007-08. India's external sector's performance deteriorated in the second half of 2007-08 and the situation became grimmer in 2008-09. In 2008-09 exports contracted by 20.5% over the first three quarters with negative growth in six out of the nine months. This reflects the decline in growth of world imports. Out of four major importers from India, who together accounted for two fifths of total exports from India, the EU, the US, and the Japan had negative growth of imports, while growth of China's imports declined from 13.5% in 2007 to 4% in 2008. Among the export oriented sectors, labour intensive sectors like textile, leather, handicrafts etc were the worst hit.

Table 2
India's merchandise export (annual and monthly)

Year	Value (US $ mn)	Growth (%)
2003-04	63,843	
2004-05	83,536	30.8
2005-06	103,091	23.4
2006-07	126,361	22.6
2007-08	162,904	28.9
2008-09		13.7
April	15,961	-7.5
May	15,550	-2.6
June	16,522	6.3
July	17,072	3.3
August	16,116	-5.6
September	13,748	-14.7
October	12,822	-6.7
November	11,505	-10.3
December	12,690	10.3

Source: Reserve Bank of India Bulletin (various issues)

The sign of recovery of Indian exports was strongly visible from October 2009 when the decline in exports in October 2009 was only 6.6% in US$ terms. India's export growth has been better than global recovery in exports, reflecting the diversification of export basket as well as export destinations. The domestic demand growth helped India counter the big fall in its export growth. As of June 2011, exports registered impressive growth with monthly exports reaching $25.9 billion. Trend in India's merchandise import during the crisis period can be understood from the following table.

Table 3

India's merchandise import (Annual and Monthly)

Year	Value (US $ mn)	Growth (%)
2003-04	78,149	
2004-05	111517	42.7
2005-06	149166	33.8
2006-07	185749	24.5
2007-08	251439	35.4
2008-09		19.4
April	24,823	5.3
May	26,684	7.5
June	25,734	-3.6
July	28,815	12.0
August	29,031	0.7
September	24,380	-16.0
October	23,360	-4.2
November	21,571	-7.7
December	20,256	-6.1

Source: Reserve Bank of India Bulletin (various issues)

Imports into India from the rest of the world grew at around 35% in 2007-08. However there was a decline in growth in the first three quarters of 2008-09 with the last four months of 2008 registering negative growth in imports. The decline in imports was the sharpest during April 2009 (-39.4%) in relation to the situation in April 2008.

India's imports of goods and services contracted faster than exports and as a result net exports turned positive during Jan-March 2009. Since October 2009, imports have registered strong growth. The declining trade performance of India was in tandem with developments in the global scenario.

The global economic recession significantly affected our IT exports. About 40% of Indian firms are exporting software services. The pattern of Indian IT exports before and after the recession is shown below.

Table 4

Pattern of Indian IT exports before and after the recession

Countries	2005-06 (%)	2008-09 (%)	2009-10 (%)
U.S.A	45	28	25.2
Canada	16	14.5	17
U.K	13.5	15.1	8.9
Germany	8	7.5	6.8
Japan	6.2	14.6	16.9
France	4.5	4	2.8
Other European Countries	5.9	8	7.5

Source: NASSCOM annual report, 2008, 2010

The U.S and Canada constituting about 60% of our buyers reduced their imports by 25 to 30% during the crisis period.

The slowdown in exports mainly affected Indian small IT firms which were mainly export based. Similarly, the impacts on IT enabled services (ITES) were much more severe, especially Banking, Financial Services and Insurance (BFSI).

The major impact of the world economic crisis is reflected in India's current account balance. During 2008-09, the current account deficit as a per cent of GDP stood higher at 2.5% as compared to 1.3% a year ago.

By the third quarter of 2008-09, the current account deficit was Rs 63000 crore which was more than double of the third quarter figures of 2007-08. The main reason for this was the high trade deficit. The last quarter of 2008-09 (Jan-March 2009) requires attention for a different reason. The significant drop in the merchandise imports during Jan-March 2009 led to a surplus during that quarter. For the first half of 2009-10 (April-September), trade deficit remained lower (US $ 58.2 billion) as compared with the corresponding period of the preceding year (US $ 64.4 billion).

Net invisibles stood lower during the first half of 2009-10 as compared with the corresponding period of the previous year. The decline in invisibles receipts was mainly attributable to the lower receipts under almost all the components of services. Invisibles payments declined, mainly due to lower payments towards travel, transportation, non-software services and private transfers. At this level, the invisibles surplus financed about 68.0% of trade deficit during April- September 2009 as against 75.4% during April-September 2008.

Despite the lower trade deficit, the current account deficit increased from US $ 15.8 billion during April-September 2008 to US $ 18.6 billion during April-September 2009 due to lower net invisibles.

2) Status of Capital Account of Balance of Payment

The main components of capital account include foreign investment, loans and banking capital. The emerging market economies experienced significant reversal in capital flows in 2008-09. Capital flight was mainly due to large outflows under portfolio investment, banking capital and short-term trade credit.

a) Foreign Direct Investment

Despite the increased risk aversion among investors and the credit crunch in international market, FDI in India has remained steady, even during the financial turbulence worldwide. This partly reflects India's sound financial structure and the consequent attractiveness of Indian market as long term investment destination. Policies undertaken by government to sustain inflows of capital have also played a positive role.

FDI inflow experienced a declining trend in the first three quarters of 2008-09, but has shown improvement in the fourth quarter. The sectors which received major part of this FDI flow are the manufacturing sector, financial services, and the construction sector. The revival in capital flows witnessed during the first quarter of 2009-10 which gathered momentum during the second quarter of 2009-10. The moderation in FDI inflows to some sectors (construction, mining and business services) in India in recent time is on account of the environment sensitive policies of the government.

b) Foreign Portfolio Investment

After a considerable period of net inflow, from the last quarter of 2007-08, foreign portfolio investment experienced a net outflow, which persisted in 2008-09. In US$ terms, during2008-09, FIIs recorded a net outflow of US$ 15.0 billion as against net inflows of US$20.3 billion in 2007-08. The main reasons behind this were the bearish market conditions, overall pessimism and a consequent flight of capital to safe destinations. However, this trend reversed in the first quarter of 2009-10 with a net inflow of US$ 8.2 billion and US$ 7.0 billion during the second quarter of 2009-10. The sharp increase in FII inflows during 2009-10 is attributable to the recovery in domestic stock markets and the comparatively better growth prospects in India.

The Raghuram Rajan Committee on financial sector reforms recommended complete opening up of FII investment into debt market without any annual ceilings. While there could be some restrictions on FII investment in government securities market pending full convertibility, this recommendation should be considered as far as the corporate debt market is concerned. First, this will allow FIIs to adjust their portfolio between bonds and equity and also expand their investment in debt on an enduring basis. Second, in times of equity market tumbling as in recent times, FIIs will use debt market for parking their funds and as such the volatility in capital flows and its consequent impact on exchange rate could be minimised.

c) NRI Deposit in Commercial Banks

Outflow of NRI deposits increased during the crisis period. Reserve Bank increased the interest rate ceiling on NRI

deposits to encourage inflows under NRI deposits and to inject new life into the foreign exchange market in the aftermath of crisis. Responding to this policy measure, net inflow increased to US$ 2.1 billion in April-December 2008-09, a revival from net outflow of US$ 0.9 billion in April-December 2007. Even during the height of the crisis, NRI deposits did not show a major downturn- reflective of the perception of the continued attractiveness of India as a long-term investment destination.

3) Foreign Exchange Reserves

Changes in foreign exchange reserves of India from 2006-07 to 2009-10 is given below. The negative impact of the crisis on foreign exchange reserves was felt during the year 2008-09. However, it was only a temporary one and the situation improved after 2008-09.

Table 5

Changes in foreign exchange reserve (US $ billion)

Year	Foreign exchange reserves at the end of financial year	Total increase/ decrease in reserves
2006-07	199.1	+47.5
2007-08	309.7	+110.6
2008-09	252.0	-57.7
2009-10 (upto Dec. 2009)	283.5	+31.5

VIII. India's New Trade Policy

India announced its new trade policy for 2009-14 on 27th August 2009. The short term objective of the new trade policy

is to arrest and reverse the decreasing trend in exports and to provide additional support to the sectors worst hit by the global recession. The announced policy aims to achieve an annual export growth of 25% by2014. The long term objective is set to double India's share in global trade by 2020.

Government aims to achieve this goal through a clutch of policy measures including fiscal incentives, institutional changes, procedural rationalization, enhanced market access across the world, diversification of export markets, improvements in infrastructure related to exports; reduction in transaction costs, and provision for full refund of all indirect taxes and levies. It is also a stated objective to encourage labour intensive sectors like textiles, leather and handicrafts, which have been the worst impacted by the recession, particularly from the point of view of job loss.

Another objective is to diversify export destinations and minimize various associated trading risks while trading with emerging market economies in Africa, Latin America and Oceania. Special importance has been given to the "Look East Policy", namely the market access agreement with South Korea and the 'Trade in Goods Agreement' with the ASEAN countries.

IX. Conclusion

The Indian economy was relatively less affected by the global crisis. While the developed world has plunged into recession, the Indian economy was affected by the "spill-over effects" of the global financial crisis. Despite recovery, advanced countries continue to face risk of recession which can have direct implications for the globalised Indian economy. Further,

there is a need to closely monitor the capital inflows from the advanced economies to ensure that they are not in excess of our domestic absorptive capacity and are not leading to the overheating of the economy. The crisis generated a shock in Indian economy particularly its external sector, but it was not catastrophic because of the special circumstances in India.

Trade diversification both in terms of commodities/ services and the regional direction shifting from traditional US and Europe to emerging markets including China and Latin America served to insulate India from global shocks emanating from the advanced countries. Moreover, India's recent growth has been driven predominantly by domestic consumption and investment. The Indian economic performance during global economic meltdown demonstrated the basic soundness and growth potential of the Indian economy.

References

1. Kumar, R T (2009), "The Global Crisis and India's External Sector" in 'Global Economic Crisis- A People's Perspective Fiasco of Neo-liberalism', Daanish Books, Delhi.
2. Annual Report 2009-2010 (2011) "The Global Economic Crisis and India's External Sector", Department of Commerce, Government of India.
3. Blanchard, Olivier (2009), "Sustaining a Global Recovery", Finance & Development, September, International Monetary Fund, Washington D.C.
4. Calvo, Guillermo (2009), "Lessons from Systemic Financial Crises", presentation at India Policy Forum 2009, New Delhi, July 14-15.
5. Dornbusch, Rudi (2001), "A Primer on Emerging Market Crises", NBER Working Paper 8326, June, Cambridge, MA.
6. CMIE (2009), "Monthly Review of the Indian Economy", Economic Intelligence, CMIE, July, p 80-81.
7. World Bank (2008), World Development Indicators 2008.
8. Bhatt R K(2011), Recent Global Recession and Indian Economy: An Analysis, International Journal of Trade, Economicsand Finance, Vol. 2, No. 3, June 2011
9. Economic Survey (2009-10) & (2010-11), Government of India, New Delhi.
10. Hand Book of Statistics on Indian Economy 2010-11, Reserve Bank of India
11. Rakshit, M. (2009), "India amidst the Global Crisis", Economic and Political Weekly, Vol. 28, No. 13, pp 94-105.
12. Reserve Bank of India Report (2009-10), Government of India, New Delhi.
13. Viswanathan, K. G. (2010), 'the Global financial Crisis and its impact on India', The Journal of International Business and Law, Vol.9, pp.41-42.

Economic Slowdown and Public Debt: An Analysis of Indian Experience

8

M.V. Suresh

I. Introduction

Notwithstanding all claims that public debt can give fillip to growth if resources mobilized via the creation of debt is invested in productive sectors, the increasing figures of public debt has caused worries for both government and policy makers in India. The incurring of public debt is generally attributed to government excesses in economic activities even in areas where it is not expected to be, like running entrepreneurial initiatives, and partly it is attributed to increasing role of government in social and other welfare augmenting areas. To streamline the public debt, and to reduce the burden of debt over a period of time, the debt management policy[1] has been put in place by the government for a long period of time. The debt management policy of government aims at accomplishing twin objectives: one is to meet the financial obligations of central government at the lowest possible borrowing rate of interest without exerting much pressure on the exchequer, and secondly, to ensure that the debt incurred always falls within the limit set by the government taking into account all existing indictors of macroeconomic development including the

revenue proceeds[2]. The policy of government includes gradual reduction in public debt that is to reduce the overall public debt to GDP ratio, which has been recognized as a suitable indicator of public debt in India. The debt incurred by the nation in early days of development could not have been avoided as the nation was then on the threshold of development, and the active involvement of government was a must. It was widely expected that once reforms got into track, the government would divest its shares in public sector institutions and it would lead finally to the plummeting of public debt in India. In this context, it would be important to look into the trends of public debt in India in the post-reform period.

Besides the above said objective, the present paper intends to examine the debt position of the country during the period of economic meltdown. It is undeniable that the problem debt is directly related to the policy of government with regard to the target of fiscal deficit (Gupta, 2011). If government plans to make fiscal deficit as low as possible, then the pressure on public debt will be relived to a great extent. In times of recent financial turbulence which emanated from the global financial meltdown, the strain on fiscal deficit had its bad consequences on the public debt position of our country. More than the increase in the quantum of public debt, it is worthwhile to delve into the nature and dimension of public debt during that time.

2. Public Debt in General

Practically, the overall debt incurred by the Government of India encompasses debt and other commensurate liabilities contracted by the government departments under the Consolidated Fund of India and the liabilities that come under the broad

head called Public Accounts (Saket, 2006). Although there have been these two classifications, it needs to be understood that the lion share of the public debt, around more than 82 per cent, appears in the form of the contracts entered in the Consolidated Fund of India, and hence for practical analysis this debt is compartmentalized into: Internal Debt and External Debt.

Table 1 Trend in the Debt Position of GoI (2004-05 to 2008-09)
(Figures in Crores)

Year	2004-05	2005-06	2006-07	2007-08	2008-09
Public Debt	1336849	1484001	1647691	1920390	2151595
Internal Debt	1275971	1389758	1544975	1808359	2028549
External Debt	60877	94243	102716	112031	123046
Other Liabilities	657573	776144	890905	917035	1007583
Total Liabilities	1994422	2260145	2538596	2837425	3159178

Source: Ministry of Finance, November, 2010

Table 2 Percentage Share in Public Debt
(Table in Percentage)

Year	2004-05	2005-06	2006-07	2007-08	2008-09
Internal Debt	63.98	61.49	60.86	63.73	64.21
External Debt	3.05	4.17	4.05	3.95	3.89
Other Liabilities	32.97	34.34	35.09	32.32	31.89
Public Debt	100.00	100.00	100.00	100.00	100.00

External Debt

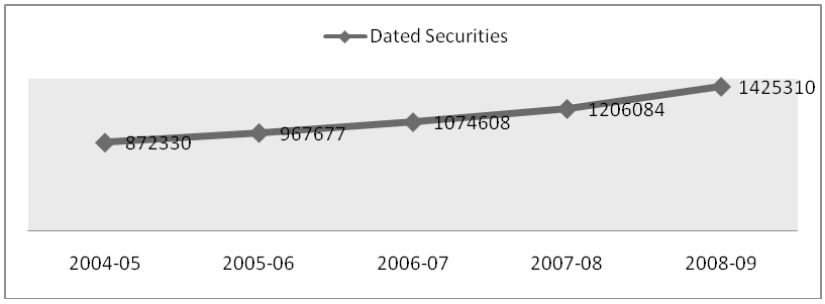
As is evident, internal debts constitute the largest share of public debt in India, and the trend continues without any noticeable change. Only in the year 2004-07, it slighted decreased to near about sixty per cent. One important thing is that external debt forms only a small part of the public debt in

India which has hovered around four per cent during the entire period. Therefore, it is obvious that the components of public debt have remained the same for the entire period under consideration, that is, from 2004-05 to 2008-09. As far as the external debt is concerned, it is not used for unproductive sectors in the country; rather they are being used mainly for funding specific projects. Another thing is that State Governments in India have not been permitted to avail of external debt directly. These have put many restrictions on availing external debt. International Development Agency, International Bank for Reconstruction and Development, and Asian Development Banks are the main sources of external debt to India.

Internal Debt

In the case of internal debt, most of the debt are in the form of fixed tenure and fixed coupon securities (Burban, 1985). The maturity period of such securities ranges from one year to seven year. Internal debt arising out of Market Stabilization Scheme (MSS) needs to be analyzed in detail. It is interesting to note that internal debt under MSS has shown much variation in the period under consideration. For instance, in 2007-08, internal debt under MSS made an unexpected jump causing many imbalances in the macroeconomic condition (Figure 1)

Figure 1 Trends in Internal Debt under MSS



Among the sub components of internal debt, dated securities and treasury bills (which do not come under MSS) form an important part, and therefore needs to be analyzed in detail. During the period under study, both have shown secular upward trend, but the dated securities have increased tremendously since 2007-08. It is unsurprising that the internal debt due to dated securities outweigh that of the treasury bills as TBs are generally low denomination debt instruments mainly used to raise fund from the money market whereas dated securities come in high denomination and they are generally used to raise money from the long term market.

Figure 2 Trends in Securities and TBs (in Million Crores)

Source: Constructed using the data of Ministry of Finance

Public account liabilities consisting of National Small Saving Fund (NSSF), provident fund, deposits, Reserve funds and other liabilities constitutes nearly 18 per cent of the total central government liabilities (GOI, 2010).

Trends in Public Debt as Per Cent of GDP

The most welcoming thing as far as the public debt is concerned is that when public debt is analyzed with respect to

GDP, we find that debt/GDP ratio witnessed a secular decline during the period under the study. In 2003-04, the public/GDP ratio stood at 43 percent whereas by 2007-08 it declined to 39 percent, although the point of decline was marginal. The decline in public debt net of MSS is highly appreciable. One can attribute this improvement in India's public debt position to two things: lowering of fiscal deficit on account of fiscal management efforts undertaken by both central and state governments and the reasonable improvement in GDP growth which India is said to have made during this period. The interesting thing is that this comfortable cushion got disturbed when the economy started adopting counter cyclical measures to prevent the spillover effects of global economic slowdown. This naturally resulted in an increase in public debt narrowly (Table No.1). The condition got further worsened when the GDP growth slowed down in response to crisis, and the public debt/GDP ratio net of MSS touched the level of 37 by 2008-09 from 35 percent in 2007-08. The increase in public debt during this time showed the excess dependence of government on debt financing to tide over the backlash effect of financial crisis.

This shows that, unlike the developed capitalist countries where the crisis severely raged, India has though worsened a much comfortable debt position.

Trends in Internal Debt as Per Cent of GDP

Internal debt as a percentage of GDP also got increased during the time of financial crisis.

In 2004-05, Internal Debt/GDP ratio was 39.4 per cent which declined to 36.4 percent in 2008-09, and as a result of financial meltdown, it again shot up to 39.7 percent by 2010-11.

It is quite interesting to note that internal debt which come under MSS really declined during the time of financial crisis thanks to decrease in foreign exchange flows to India. This is evident from the fact that internal debt under MSS/GDP ratio declined to 1.6 per cent in 2008-9 from 2 percent in 2004-05. On the contrary, during the same period internal debt due to market loans shot up from 37.4 per cent in 2004-05 to 38.7 per cent in 2010-11 (GOI, 2010).

Trends in External Debt as a Per Cent of GDP

The public debt trend brings us a different picture when it comes to the case of external debt of India. Surprisingly, external debt at current exchange rate as a percentage of GDP has slowed down in India during the period under consideration that is from 2004-05 to 2010-11 (GOI, 2010). What is welcoming is the fact that more than 80 percent of this external debt comes from multilateral institutions at concessional rate of interest. One can compare this with the high cost external funds which India had to avail of from international financial institutions like IMF and World Bank on the threshold of severe balance of payment crisis in 1991. Another encouraging development is that during this time India received assistance from friendly nations[iii] G-8 Nations and European Countries are the main countries providing financial assistance to India (GOI, 2010).

Concluding Remarks

Public debt has continued to be an important problem for Indian economy. The problem of public debt becomes serious and its dimensions may turn out to be unmanageable when the country is caught in a severe economic crisis, that too, when the crisis is an imported one. The above analysis clearly shows that the economic slowdown adversely impacted

the public debt position of our country. While internal debt got worsened, India experienced some relief on the side of external debt. The excess dependence on market loans was the main reason for the worsening of internal debt. This obviously shows that the overreliance on market loans should be gradually reduced so as to prudentially manage the public debt position of the country.

End Notes

i. Fiscal Responsibility Budget Management Act (FRBM Act) is an important step towards accomplishing this (Topolova & Nyberg, 2010)

ii. It needs to be mentioned here that although the problem of public debt has been viewed as serious in the country both by the government and policy makers, it has been found that in the long run the debt problem in India is sustainable (Kaur & Mukherji, 2012)

iii. G-8 Nations and European Countries are the main countries providing financial assistance to India (GOI, 2010).

References

1. Burban, K. (1985). *Public Debt Management in India.* New Delhi: Uppal Publishing House.
2. GOI. (2010). *GOVERNMENT DEBT: Status and Road Ahead.* New Delhi: Ministry of Finance Saket, N. (2006). *Public Debt and Economic Planning in India.* New Delhi: Deep and Deep Publications.
3. Topolova, P., & Nyberg, D. (2010). What Level of Public Debt Could India. *IMF Working Paper* , 20-36.
4. Gupta, J. R. (2011). *Public Economics in India.* New Delhi: Atlantic.
5. Kaur, B., & Mukherji, A. (2012). Threshold Level of Debt and Public Debt. *Reserve Bank of India Occasional Papers* , 1-37.

The Need for Fiscal Policy Revamp in India: An Analysis of Current Scenario

9

Anjali Prakash

Abstract

The impact of fiscal deficit on economic growth is one of the highly debated issues in all world economies. The target of achieving sustained growth and maintaining macroeconomic stability is the dream among many developed, developing and underdeveloped economies. The economic growth and stability of developing countries in recent times has brought the issues of fiscal deficit into sharp focus. Continuing high levels of fiscal deficit, even if adoption of fiscal Responsibility and Budget Management Act (FRBM), pose a serious danger to macroeconomic stability in India. The excessive fiscal deficits seem to be the major concern of academicians and policy makers in India.

Key Words

Fiscal deficit, Fiscal Responsibility and Budget Management Act.

I. Introduction

Fiscal consolidation is necessary for sustained growth in an environment of macroeconomic and financial stability. India's successful stride towards fiscal consolidation adhering to the FRBM Act, 2003 was commendable. However, the

endeavor was hampered by unprecedented crisis emanated from the developed world. The expansionary fiscal policy pursued to cope with the global developments, and its continuation well into 2010-11 produced adverse macroeconomic repercussions thereafter. Growing fiscal deficit limits the effectiveness of monetary policy in maintaining interest rate at desirable levels. Mounting fiscal deficit unveils the underlying structural imbalances the Indian economy is currently exposed to. IMF projection states that India's growth rate is expected to slow to 4.6 per cent this fiscal year demonstrating global development and domestic supply constraints. India's worsening fiscal position has been creating serious apprehensions about its future growth trajectory.

II. Objectives of the Study

This article attempts to validate the need for a restructuring of strategies on fiscal policies for better fiscal consolidation by assessing the current fiscal status of India.

II. Methodology

An analysis of current state of fiscal health is attempted by examining the performance of key deficit indicators, revenue buoyancy and corresponding expenditure, non plan expenditure and internal debt liability. Secondary data from various reports of Government of India, Reserve Bank of India, Planning Commission, IMF, etc are used.

III. Empirical Studies

Experience of many economies that fell into serious macroeconomic crisis states the need for effective fiscal

consolidation. The study has reviewed some important empirical studies on fiscal deficit and economic growth.

Jorge C. Avila (2011) analyzed the relationship between fiscal deficit, macroeconomic uncertainty and growth of Argentina for the period 1915-2006, and concluded that the deficit hampered on per-capita income growth in Argentina through the volatility in relative prices. Goher Fatima et al. (2011) aimed at verifying the impact of government fiscal deficit on investment and economic growth using time series of thirty years stretching between 1980 and 2009 and believed that fiscal profligacy has seriously undermined the growth objectives thereby adversely impacting physical and social infrastructure in the country. Christopher S. Adam and David L. Bevan (2002) examined the relation between fiscal deficits and growth for a panel of 45 developing countries and found a possible non-linearity in the relation between growth and the fiscal deficit for a sample of developing countries. The negative impact of fiscal deficits on long-run growth has been empirically documented in several studies, such as Fischer (1993), Easterly and Rebelo (1993), Easterly, Rodriguez, and Schmidt-Hebbel (1994), Bleaney, Gemmell, and Kneller (2001). Fisher (1993) found that larger budget surpluses were strongly associated with more rapid growth through greater capital accumulation and greater productivity.

IV. Analysis and Discussion

Performance of key fiscal indicators in the form of revenue deficit, fiscal deficit and primary deficit puts India's macroeconomic policy framework in a dubious position.

Persistence of revenue deficit has been obstructing the efforts to contain the displeasing figures of fiscal deficit.

TABLE.1

KEY DEFICIT INDICATORS (as % of GDP)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit
2003-04	3.5	4.3	0.0
2004-05	2.4	3.9	0.0
2005-06	2.5	4.0	0.4
2006-07	1.9	3.3	-0.2
2007-08	1.1	2.5	-0.9
2008-09	4.5	6.0	2.6
2009-10	5.2	6.5	3.2
2010-11	3.2	4.8	1.8
2011-11	4.4	5.7	2.7
2012-13	3.6	4.9	1.8
2013-14(BE)	3.3	4.8	1.5
2013-14(RE)	3.3	4.6	1.3
2013-13(P)	3.2	4.5	1.2

Source: Economic Survey 2014-15.

Since the implementation of FRBM Act, 2003 economy had performed exceptionally well to limit fiscal deficit below the threshold target level (3% of GDP) until 2007-08. This steady performance was badly hit by global crisis which prompted

the economy for policy reforms. Continuation of expansionary fiscal policy stance (initiated during global crisis) well into 2010-11 produced inflationary pressures, necessitating, a tightening of monetary policy.

TABLE. 2

TRENDS IN FISCAL DEFICIT

Year	Fiscal deficit (in crores)	Growth in Fiscal deficit (%)
2004-05	125794	2
2005-06	146435	16.4
2006-07	142573	-2.6
2007-08	126912	-11
2008-09	336992	165.5
2009-10	418482	24.2
2010-11	373592	-10.7
2011-12(P)	509732	36.4
2012-13(BE)	513590	0.8

Source: Economic Survey 2013-14.

In the post-FRBM period, the figures of fiscal deficit for two years, 2008-09 and 2011-12 stand out. The former slippage was policy driven and foreseen, while the latter was the outcome of the adverse global and domestic factors that the economy failed to succumb. Dismal performance of the industrial sector, surged levels of inflation and meek financial market conditions contributed to the state of affairs in 2011-12.

Adverse investment climate that followed tight monetary policy slowed down investments and further GDP growth limiting its revenue raising capacity. Restricted revenue buoyancy of the economy coupled with rising revenue expenditure aggravated revenue deficits. (Table.3)

TABLE. 3

REVENUE RECEIPTS AND REVENUE EXPENDITURE (as % of GDP)

Items	2009-10	2010-11	2011-12	2012-13	2013-14 (BE)	2013-14 (RE)	2013-14 (P)
Revenue receipts	8.8	10.1	8.3	8.7	9.3	9.1	8.9
Revenue expenditure	14.1	13.4	12.7	12.3	12.6	12.4	12.1

Source: Economic Survey, 2014-15.

Sluggish growth in the Tax-GDP ratio and tax revenue (direct & indirect) shows the reduced tax buoyancy of the economy. This is evident in the following table.

TABLE.4

TAX – GDP RATIO, TAX (DIRECT & INDIRECT) AS % OF GROSS TAX REVENUE

Year	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14(BE)	2013-14(RE)	2013-14(P)
Tax-GDP Ratio	11.9	10.8	9.6	10.2	9.9	10.2	10.9	10.2	10
DT as % of GTR	49.9	52.8	58.9	55.3	54.9	53.4	53.5	54.4	55.9
IT as % of GTR	47.0	44.5	39.2	43.4	44.1	45.7	45.7	44.8	43.8

Note: DT –Direct Taxes, IT – Indirect Taxes, GTR- Gross Tax Revenue.

Source: Economic surveys (2012-13, 2013-14)

A downward revision was done in the total direct tax collection from 6, 61389 crores to 630821 crores in 2013-14 RE

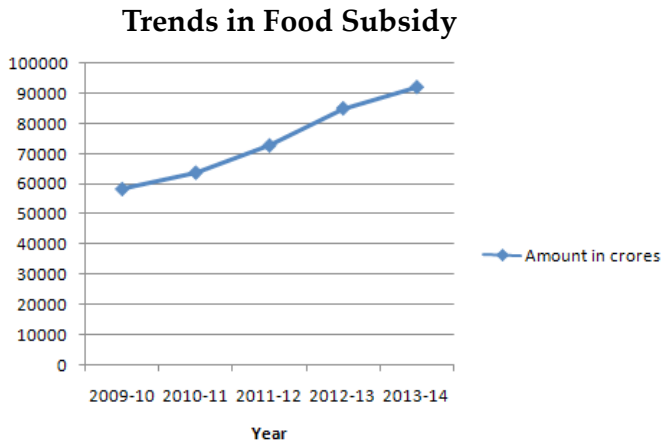
owing to a decline in both income and corporation tax revenues. A similar cut had to be done for indirect taxes from an estimated figure at Rs 5, 64,254 crore to R 5, 18,770 crore in RE 2013-14. The fall in revenue generation encompasses all forms of indirect taxes namely excise duties, customs and service taxes. However, the structure of tax system managed to adhere to the principle of equity in taxation, ensuring a higher share of direct taxes than indirect taxes.

TABLE. 5
PLAN AND NON PLAN EXPENDITURE

Year	Plan Expenditure	Non Plan expenditure
2009-10	4.7	11.1
2010-11	4.9	10.5
2011-12	4.6	9.9
2012-13	4.1	9.9
2013-14(BE)	4.9	9.8
2013-14 (RE)	4.2	9.8
2013-14(P)	4	9.8

Source: Economic Survey 2013-14

Setback in revenue generation necessitated an inevitable cut in plan expenditure. However burgeoning non plan expenditure depicting a steady growth exerted severe pressure on financial position. Non plan expenditure as percentage of GDP remained steady at 9.8 per cent. Interest payment and subsidies, among which, food subsidy in particular, appropriated major proportion of centre's non expenditure.



Source: Economic Survey 2013-14

V. Accumulation of Internal Debt

Growing fiscal crisis is also manifested in the form of accumulation of debt, specifically internal debt. With high and persistent fiscal deficits, the borrowing requirements of the Centre have remained significantly large. Internal debt as % of total debt has been increasing since 2010-11 and stood at 37.7% as percentage of GDP during 2013-14.

TABLE.6
COMPOSITION OF CENTRAL GOVERNMENT'S PUBLIC DEBT (as % of Total)

Years	Internal Debt		External Debt	
	% of total debt	% of GDP	% of total debt	% of GDP
2006-07	88.11	34.7	11.89	4.7
2007-08	88.63	32.8	11.37	4.2
2008-09	88.02	34.5	11.98	4.7
2009-10	90.35	36	9.65	3.8
2010-11	90.56	34.3	9.44	3.6
2011-12	90.88	35.8	9.12	3.6
2012-13	91.84	37.3	8.16	3.3
2013-14	92.59	37.7	7.41	3

Source: Public Debt Management: Reflections on Strategy & Structure, 9th Annual International Conference on "Public Policy & Management" at Indian Institute of Management, Banglore on August 11, 2014.

The persistence of large fiscal deficits and the increased market borrowings exerted upward pressures on interest rates. This crowded out private investment, potentially weakening the growth prospects. Interest payments as a proportion of GDP had been falling in the post FRBM phase. However, following the expansionary fiscal policy and tight interest rate policy, interest payment as a percentage of GDP increased, eventually leading to an accumulation of liabilities. The average cost of borrowing rose to 8.3% in 2013-14 (RE) which was 7.5% in 2009-10 (Table.7).

TABLE.7
OUTSTANDING INTERNAL LIABILITIES OF CENTRAL GOVERNMENT (in Crores)

Years	Outstanding internal liabilities	Interest on internal liabilities	Average cost of borrowing (% per annum)
2009-10	2874683	192567	7.5
2010-11	3212521	212707	7.4
2011-12	3765153	251634	7.8
2012-13	4295575	290278	7.7
2013-14(BE)	4856266	347888	8.1
2013-14(RE)	4782585	355438	8.3

Source: Economic survey 2014-15.

VI. Concluding Remarks

The above analysis of India's fiscal scenario underscores the rationale for the formulation of a growth oriented fiscal package that would place the economy back to its growth trajectory. The emphasis should be on the quality of fiscal adjustment, driven by rationalization of expenditure, revenue buoyancy, better targeting of subsidies, creation of favorable investment climate, improved tax administration etc., for a stronger recovery of growth process.

References

1. Adam, C. S., and D. L. Bevan, (2005), "Fiscal Deficits and Growth in Developing Countries", Journal of Public Economics, Vol.89, pp: 571– 597.
2. Bleaney, M. F et al. (2001),"Testing the Endogenous Growth Model: Public Expenditure, Taxation and Growth over the Long- Run." Canadian Journal of Economics, Vol. 34, No.1, pp: 36–57.
3. Easterly, W. & S. Rebelo, (1993), "Fiscal policy and economic growth: An empirical
4. Investigation," Journal of Monetary Economics, Elsevier, Vol. 32, No.3, pp: 417-458.
5. Easterly, W. et al. (1994), "Public Sector Deficits and Macroeconomic Performance", Oxford and New York: Oxford University Press for the World Bank.
6. Fisher, S., (1993), "The role of Macroeconomic factors in growth", Journal of Monetary
7. Economics, vol. 32, No 3, pp: 485-512.
8. Goher Fatima, Ather Maqsood Ahmed, and Wali Ur Rehman (2011), "Fiscal Deficit and
9. Economic Growth: An Analysis of Pakistan's Economy, International Journal of Trade",
10. Economics and Finance, Vol. 2, No. 6, pp: 501-504.
11. Government Debt, Status Paper (2013), Ministry of Finance, Department of Economic Affairs, July.2013.
12. Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2013-14
13. Jorge Avila (2011), "Fiscal Deficit, Macro-Uncertainty, and Growth in Argentina", CEMA Working Papers no-456.
14. Muneesh Kapur and Rakesh Mohan (2014), India's Recent Macroeconomic Performance: An Assessment and Way Forward, IMF Working Paper, WP/14/68.
15. Public Debt Management: Reflections on Strategy & Structure, 9th Annual International Conference on "Public Policy & Management" at Indian Institute of Management, Bangalore on August 11, 2014.

Food Inflation in India - Trends and Causes

10

Anilkumar . P

Abstract

The undulating changes in the overall food price inflation have remarkable effect on the macroeconomic stability, thus decreasing the purchasing power of most households. The congenial policies taken by the agriculture initiatives had a great implication in managing food inflation trends. Though FAO food price index is in line with India's whole sale price index, food inflation of latter was exhibited in different phases. Increased share of food expenditure in total household expenditure is directly correlated with the food inflation in developing countries. Though the present fiscal deficit and monetary expansion are the root cause of increased food prices, three variables are found to be basically impinging on food inflation: deficits, domestic supply and global food prices.

I. Introduction

India has been facing the problem of food inflation for the last few years. Food price inflation was found not only threatening macroeconomic stability but also decreasing the purchasing power of most households, especially the poorer ones, for whom food consumption constitutes a relatively large share of total expenditures. Therefore it is high time to analyze

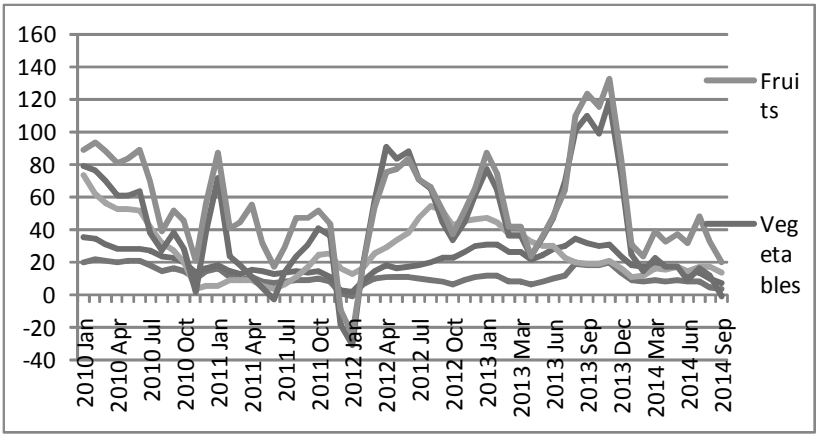
the problem of food inflation with appropriate policies to keep food prices stable. Studies conducted by various agencies revealed that the factors related to supply, trade, global prices, food mismanagement, speculative activities and demand and the structural change of the economy resulted in acceleration of food inflation and the abnormally high level of food prices. However, the FAO food price index and the Indian whole sale price index showed the same trend which deals with the unacceptable rise in the food prices in countries whether developed or developing. This paper focuses the trends and causes of food price inflation in India in the recent period.

II. Recent Trends in Food Inflation

During the period 2010-14, India has witnessed drastic changes in the food inflation rates. The Whole sale price index (WPI), an index of food inflation, was introduced in the year 1907. It is calculated on the basis of average rate of change in the wholesale market. According to the Ministry of Statistics and Programme Implementation (MOSPI), peak inflation rate was observed in February 2010 (Fig.1) for food articles (21.85%) and in September 2013 for vegetables (97.72%). Apart from these other food items- cereals (19.08 %), pulses (38.06 %), fruits (44.44%), meat, egg and fish (17.66 %), spices (16.86%), milk (15.24%), tea and coffee (13.37%) have also faced the same situation during this period. Thus, a vast majority of the commodity subgroups under each food articles group were subject to high average inflation rate, implying that the impact of food articles price build-up was broad-based. This might probably be due to the price pressure faced by our food items. However, the food inflation falls from a double digit to single

digit in January 2014 where it was highly pronounced in vegetable prices from February 2014 than that of the previous months. The congenial policies taken by the agriculture initiatives and the domestic macroeconomic management in food prices as well as the favourable monsoon had a great implication over food inflation trends.

Fig.1. Monthly Food Inflation Rate (2010-14)



Source: MOSPI

A wide difference was also observed in the rural and urban food inflation rate where it can be analyzed efficiently by means of consumer price index (CPI). The WPI based inflation rate, which is measured on point-to-point basis, is somewhat different from that of CPI based inflation. CPI is the weighted average rate of change in prices of a set of goods and services purchased by consumer on monthly basis. Thus CPI is more comprehensive and consumer oriented. Data on the CPI based all India inflation rate (Table 1) by MOSPI for February 2013-14 reveales that there is a difference in the corresponding inflation rates for rural and urban areas. The

overall inflation rate was found to be higher in the rural area (8.51 %) than the urban area (7.55 %). A similar trend was also observed in the case of food and beverages where the inflation rate was found to be 9.27 and 7.10 per cent respectively.

TABLE 1.
COMMODITY WISE ANNUAL INFLATION RATES OF RURAL AND URBAN AREA
(February 2013-2014)

Category	Rural			Urban		
	Feb.13 Index Final	**Feb.14 Index**	**Rate (%)**	**Feb.13 Index Final**	**Feb.14 Index**	**Rate (%)**
1. Cereals and products	124.8	137.8	10.42	125.1	135.7	8.47
2. Pulses and products	115.4	120.1	4.07	114.5	116.7	1.92
3. Oils and fats	143.3	145.2	1.33	147.9	138.8	-6.15
4.Egg, fish and meat	134.9	148.4	10.01	138.6	151.3	9.16
5. Milk and products	135.9	149.3	9.86	130.8	145.4	11.16
6. Condiments and spices	128.5	138.1	7.47	124.6	138.4	11.08
7. Vegetables	124.1	145.2	17.00	116.8	125.4	7.36
8 .Fruits	139.7	163.9	17.32	134.4	152.7	13.62
9 .Sugar etc	111.8	107.2	-4.11	110.0	100.1	-9.00
10. Non-alcoholic beverages	128.5	138.6	7.86	130.0	140.2	7.85
11. Prepared meals etc	128.0	139.3	8.83	131.0	142.2	8.55
12. Food and beverages (1 to 11)	128.4	140.3	9.27	128.1	137.2	7.10
13. Fuel and light	131.2	139.8	6.55	129.2	136.2	5.42
14. Clothing, bedding and footwear	136.4	149.8	9.82	137.3	148.4	8.08
General Index (All Groups)	128.1	139.0	8.51	125. 8	135.3	7.55

Source: MOSPI

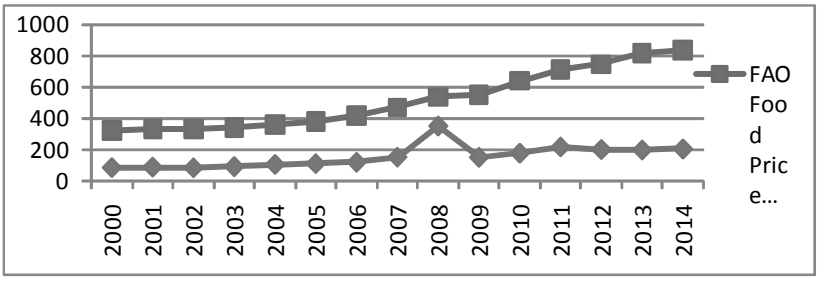
TABLE 1.a.
COMMODITY WISE ANNUAL INFLATION RATES OF RURAL AND URBAN AREA
(February 2013-2014)

Combined		
Feb.13 Index Final	**Feb.14 Index**	**Rate (%)**
124.9	137.3	9.93
115.1	119.1	3.48
144.8	143.1	-1.17
136.2	149.4	9.69
134.0	147.9	10.37
127.4	138.2	8.48
121.8	138.9	14.04
137.4	159.1	15.79
111.3	105.2	-5.48
129.1	139.3	7.90
129.5	140.7	8.65
128.3	139.3	8.57
130.4	138.4	6.13
136.7	149.3	9.22
127.1	137.4	8.10

Source: MOSPI

The hike in food price index was observed uniformly throughout the world. The food price index data of Food and Agriculture Organization (FAO) and that of India's WPI by MOSPI during 2000-2014 showed a similar trend where the food price index of FAO increased from 235.22 to 632.15 while that of India's WPI 85 to 201.25. Though the financial crisis during 2008 has reflected on India's WPI, the food prices were ruling high throughout the world. Fig. 2. shows that the global food inflation which started building up from August 2005 remained highly volatile until March 2006. A significant rush forward in food prices was also witnessed by the world from April 2006 onwards which firmed up until September 2008.

Fig 2. Food Price Index and Whole Sale Price Index (2000-2014)

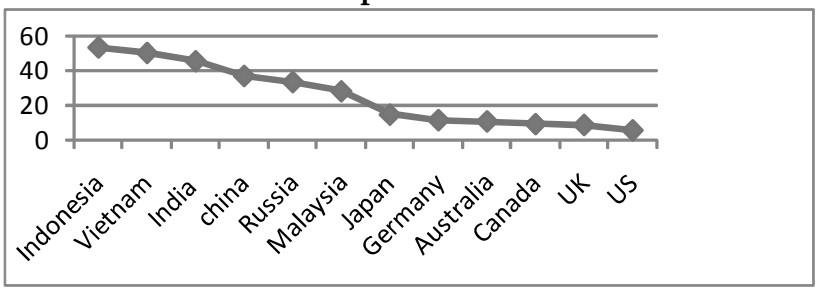


Source: FAO

The food inflation in India can be classified into three phases: Phase I from 2006 to 2008 (high food prices), Phase II from 2009 to 2010 (slight food inflation), and Phase III from 2010 to September 2014 (moderate food inflation).

Share of food expenditure in total household expenditure is directly correlated with the food inflation in developing countries. However, the food expenditure of people in India recorded almost forty five percent of the total expenditure (Fig 3.), when compared with advanced economies and it leads to low saving capacity and food price hike.

Fig 3. Share of Food Expenditure in Developing and Developed Countries



Source: FAO, NSSO's 68th round.

Thus, the emerging economies average food consumption expenditure is seven fold more than advanced countries. However the market economies there is a problem of food price inflation.

III. Factors Responsible for Food Inflation

In order to understand Indian food inflation, it is necessary to analyse the factors that influence it. RBI considers the Whole sale Price Index (WPI) as the most relevant variable for measuring the overall food inflation in the country. It has also a leading role in determining favorable policies for agricultural producers and consumers. The WPI measures the price of a representative basket of wholesale goods. In India, wholesale price index is divided into three groups where food Articles from the Primary Articles Group account for 14.30 per cent of the total weight (Ministry of Agriculture, 2014). The findings from various literature pointed out that there are basically three types of variables that impinge on food inflation: i) policy variables especially related to deficits (budget, revenue, fiscal) and those related to monetary expansion, ii) domestic supply shocks and iii) global food inflation.

1. Fiscal and Monetary Measures

In macroeconomic point of view the present fiscal deficit and monetary expansion results in the boost of agriculture prices. Studies revealed that excess money leads to long run-inflation which lowers the real output. It is pointed out that one percent increase in fiscal deficit increases money supply by more than 0.9 per cent. Thus without monetary expansion, inflation cannot occur. Apart from these subsidies, an essential part of the government budget, affect the inflation in one way

or other. Though sufficient subsidies are provided, it is not effective in reducing the food inflation. Export and import leads to rise in food price to a certain extent.

The Government has introduced a lot of fiscal measures to meet the fiscal deficit. One among these is expected to be reduction in government spending by around 0.3 per cent of gross domestic product, which in turn will affect the subsidies. This will also affect the food inflation. Indian fiscal package also boost the consumption through liberal increases in pay to organized workers and also through employment generation programmes for rural and urban areas. Though this will result in increased demand, supply faces certain bottlenecks in agriculture, power and irrigation sectors which lead to the tendency 'too much money was chasing too few goods'.

2. Domestic Supply and Demand

A major cause of the food price hike in India is the new globalization policies which promotes development among middle men. Apart from this, when the demand side is concerned, the rural farm wages and increase in real consumption are highlighted as the major reasons for food inflation. Most of the literature pointed out that the share of per capita food expenditure has decreased due to the structural shift from food consumption to protein based food items.

Meanwhile, these changes have also been seen in the production and supply side. Supply affects inflation by means of three ways which subsequently need an appropriate policy action: supply shock- which is like an exogenous factor, not permanent in nature; supply bottleneck- which is endogenous to a system and can be answered by catering to the supply-

side logistics and other support mechanisms; and supply inelasticity- which requires substantial investments. While considering the supply side, food price inflation is the result of dynamic forces that occur both at the farm where the raw agricultural ingredients for retail food items are produced, and along the marketing chain as the farm output is transformed and moved to the retail customer. A series of costs are imposed on the price of the raw agricultural commodity, including handling, transportation, storage, and processing, as well as the insurance, financing, and advertising costs necessary in order to move the product to the retail customer. These marketing costs vary widely for different retail food products depending on the degree of processing and transformation. Thus the economic forces such as higher energy costs or increased labor rates do not impact all food categories equally. More highly processed food products are less influenced by farm level price changes than are those food products that have very little marketing and processing as part of the final retail product.

IV. Conclusion

The paper highlights the trends and causes of food inflation in India during the period from 2010 to 2014. The total fluctuation in food prices was classified in to three phases: high food prices, slight food inflation and moderate food inflation. The congenial policies taken by the agriculture initiatives as well as the favourable monsoon led to the reduction in food inflation from January 2014. Comparative evaluation of the overall inflation rate between the rural and urban areas revealed that the inflation rate was higher in the

rural area when analyzed by means of consumer price index. The share of food expenditure over the total expenditure also had a direct correlation with food inflation rate. Though the present fiscal deficit and monetary expansion are the root cause of increased food prices, three variables are found to be basically impinging on food inflation: deficits, domestic supply and global food inflation. In that context, monetary and fiscal policy has to be effective in looking forward the food inflation based on which the policy decisions has to be generated.

References

1. Agriculture Statistics at a Glance, Various Issues, Ministry of Agriculture, Government of India, Available at http://eands.dacnet.nic.in/latest.htm.
2. Bandara, J. S. 2013. *'What is Driving India's Food Inflation? A Survey of Recent Evidence*', South Asia Economic Journal. 14(1):127-156
3. Chand, R. 2010. '*Understanding the Nature and Causes of Food Inflation'*, Economic and Political Weekly, 45:10 - 13
4. Commission for Agricultural Costs and Prices (CACP), Ministry of Agriculture, Government of India, Available at http://cacp.dacnet.nic.in/
5. Commodity price data (Pink Sheet), World Bank, Available at http://www.worldbank.org/
6. Guha, A. and Tripathi, A. 2014. *"Link between Food Price Inflation and Rural Wage Dynamics"* Economic and Political Weekly. 49: 26 - 27
7. Subbarao, D. 2011. "*The Challenge of Food Inflation*", Presidential Address delivered at the 25th Annual Conference of the Indian Society of Agricultural Marketing at Hyderabad.