



## Redesigning and Rebuilding Growth Process in the Indian Economy

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I am truly delighted and indeed honoured to have been invited to deliver the Keynote Address for this National Conference on **Recession, Recovery and Resurgence: Responses in the Indian Economy**. At the outset, let me congratulate Justice K.S.Hegde Institute of Management, Nitte for having organized this National Conference on a theme of great contemporary relevance.

The theme of this Conference is: "Recession, Recovery and Resurgence". Interestingly, the 2010 World Economic Forum (WEF) Annual Meeting in Davos, Switzerland, has the organizing theme for this year as, "Improve the State of the World: Rethink, Redesign and Rebuild". That is three more R's. What I propose to do in this Keynote address is to add my own R i.e., 'Review' of all these six R's viz., 'Recession, Recovery, Resurgence', 'Rethink, Redesign and Rebuild'. I would like to review the developments relating to 'Recession, Recovery and Resurgence' in different parts of the global economy with special reference to the policy responses in the Indian Economy. Let me begin by recounting global economic growth and world trade integration since the 1991, which happens to be the earlier inflexion point for the global economy as well as for the Indian economy before the onset of the latest global economic crisis.

### 1. Global Economy: Turbulence and Stability

Over the years, global economy has come a long way, passing through ups and downs and witnessing phases of turbulence and stability in turns. Recovering from the two oil shocks in the 1970s and Latin American Debt Crisis of the 1980s, the world economy was subject to a series of regional crises in the decade of 1990s including the exchange rate mechanism (ERM) Crisis in the European Monetary System (1992-93), Mexican Crises (1994), East Asian Crisis (1997-98),

Russian Crisis (1998), Brazilian Crisis (1998-99) and with the turn of the Century, Argentine and Turkish Crises in 2001. Notwithstanding these crises, the world economy recorded a monotonic growth throughout the 1990s except for a dip during the East Asian Crisis and recorded on average real GDP growth of 3.1 per cent during the period 1991-2000.

When the New World Economic Order was established towards the end of the World War II, these countries (or groups) were deemed to be the engines of growth for the world economy, i.e., the U.S., Western Europe and Japan. When one (or even two) of them faltered, it was expected that the remaining engine(s) of growth would take on the mantle of maintaining the momentum for the world economy. This actually happened almost unabatedly up to the year 2000, when a striking new phenomenon became evident i.e., emergence of what is now referred to as Emerging Market Economies (EMEs).

As a matter of fact, throughout the 1990s emerging and developing economies consistently outperformed the Advanced Economies. According to World Economic Outlook (2009) published by the IMF, the average annual real GDP growth rate during the period 1991-2000 placed at 2.8 per cent for advanced economies was distinctly lower than the corresponding growth rate of 3.6 per cent posted by emerging and developing economies. A subset of the latter group of countries referred to as Developing Asia in fact registered an impressive average annual real GDP growth rate of 7.4 per cent during the same period.

With the turn of the century, advanced economies as a group distinctly slowed down. From the decadal average growth rate of 2.8 per cent during the 1990s, their real GDP growth rate in 2001 decelerated to only 1.2 percent. The deceleration was especially

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pronounced in respect of the main engine of global GDP growth i.e., the US, whose growth rate decelerated from the average of 3.3 per cent during the 1990s to only 0.8 per cent in 2001. The other two traditional engines of global GDP growth i.e., Western Europe and Japan who had not done well in the 1990s decelerated further to barely 0.2 per cent. While the advanced economies were slowing down in 2001, in contrast, the emerging and developing economies as a group, started gaining further momentum to economic growth, accelerating their growth rate from 3.6 percent during the 1990s to 3.8 per cent in 2001.

During the first seven years of the latest decade (i.e., between 2001 – 2007), the differential in growth performance between major advanced economies on one hand and emerging and developing economies on the other, became even sharper. Illustratively, the average real GDP growth of advanced economies at 2.3 per cent was much lower than that of emerging and developing economies placed at 6.5 per cent and was in fact significantly lower than that of Developing Asia which posted a growth rate of 8.4 per cent during the seven year period.

The difference in growth performance becomes strikingly evident when individual country comparisons are made between the two groups. During the period 2001-07, the average real GDP growth was 2.3 per cent for the USA, 1.9 per cent for the Euro Area and only 1.5 per cent for Japan. In contrast, during the same period, the average real GDP growth was 10.4 per cent in China, 7.3 per cent in India, and 5.1 percent each in Malaysia and Thailand. Within emerging and developing economies group. Elsewhere in Africa, Nigeria and South Africa posted notable performances – recording 7.1 per cent and 5.1 per cent growth respectively during the four-year period (2004-07). Likewise, in Latin America, Brazil and Mexico showed a good performance – registering real GDP growth in the range of four to five per cent during the four-year period ending 2007. Clearly, thus, within the developing country group, a small set of countries had achieved

an impressive performance over almost two decades up to the onset of the global economic crisis and made themselves systemically important for the global economy as a whole. These countries, now being loosely referred to as Emerging Market Economies (EMEs) include, among others, China, India, Brazil, Mexico and South Africa

The systemic importance of EMEs in terms of driving and sustaining global growth process needs to be understood clearly. According to one estimate by the IMF (World Economic Outlook Database 2004), in 2003 the contribution to global GDP growth (valued in terms of purchasing power parity –PPP principle) of the three additional engines of growth i.e., the USA (18.6 per cent), Euro Area (7.1 per cent) and Japan (5.3 per cent) in the aggregate was, in fact, *lower* than that of China (23.5) and India (8.6) combined. In other words, before the outbreak of the global crisis in September, 2008, the balance of sustaining the global growth momentum has shifted from Advanced Economies like the USA, Western Europe and Japan to Emerging Market Economies (EMEs), particularly to China and India.

These developments on the economic growth front were of course, fully reflected in international trade and global trade integration. The world exports of goods and services which averaged US\$ 6.1 trillion during the 1990s (i.e., 1991-2000) rose steadily (in value terms) reaching US \$ 19.7 trillion by the year 2008. It may be noted that underlying variation in the volume of exports during this period was generally less pronounced than the dollar value of exports, indicating that international price volatility had been a dominant factor in the steady expansion of global trade. (Illustratively, the oil price which averaged \$ 18.73 per barrel during the 1990s rose steadily to \$ 28.9 per barrel in 2003 and shot up thereafter, reaching US\$ 97 per barrel on average by the year 2008).

Going by the data available in World Economic Outlook 2009 published by the IMF, the volume of world exports

of goods and services seems to have closely mirrored the ups and downs in the growth rate of the global economy. The volume of world exports of goods and services seems to have closely mirrored the ups and downs in the growth rate of the global economy. The volume of world exports in goods and services recorded a strong economic growth of 7.1 per cent during the 1990s, but with the deceleration in the overall economic growth rate in 2001. The exports volume growth rate also declined sharply to only 0.3 per cent. The export volume picked up thereafter recording a growth rate of 10 per cent on average for the period 2001-07. In other words, the slowdown in the global growth rate from the 1990s to the period 2001-07, was also reflected in decelerating volume of world exports.

For advanced economies as a group, the growth in volume of exports of goods and services, which was placed at 6.9 per cent in 1990s, sharply decelerated posting a negative growth (-0.4) per cent in 2001 with the slowdown of their economic growth, but gathered some momentum thereafter, recording an average growth of 5.0 per cent during the first seven years of the latest decade. On other had, as far as Emerging and Developing Economies are concerned, with the significant growth acceleration during the 1990s and the period 2001-07, the volume of exports of goods and services also rose in step, accelerating from 8.4 per cent to 9.3 per cent over the period.

Interestingly, openness of the world economy as measured by exports – GDP ratio shows a distinct upward trend, especially for the Low and Middle Income countries. According to the World Bank data (World Development Indicator Online Database), the export-GDP ratio for the world rose from 19.1 per cent in the first half of the 1980s to around 22.9 per cent during the second half of the 1990s. During this period spanning two decades, the openness of High Income countries increased only marginally from 19.7 per cent

to 22.2 per cent. In contrast, the openness of the Low and Middle Income countries increased significantly from 16.3 per cent to 25.8 per cent during the same period.

A major reason for the increase in global openness to trade has been the unilateral trade liberalization measure adopted by a large number of developing countries over the two decades. Several of the developing countries replaced their earlier inward-looking import-substitution strategies by more outward-looking development strategies. Over this period, they also substantially reduced their tariff as well as non-tariff barriers to international trade.

The surge in world trade during the decade and a half before the global crisis had the effect of substantially improving the level competitiveness across the world. Integration with the world economy for countries which were largely inward-looking earlier also meant substantial productivity improvements. Given the fact that exports accounted for around one-fourth of the global GDP, evidently developments in world trade had emerged as a major determinant of GDP growth as well as employment.

It was against this backdrop that arguably, the worst economic crisis since the Great Depression of the 1930s hit the world economy. The sub prime crisis that occurred in August 2007 in the USA subsequently turned into a full blown global recession with dramatic escalation of the global financial crisis in 2008. This global crisis was undoubtedly one of the severest shocks not only for advanced economies and then on to emerging market economies (EMEs) through the financial, trade and expectation channels.

Earlier hopes that it was essentially a financial crisis and therefore it would only have a limited impact on the 'real' economy were squashed. As a matter of fact, in October 2009 the world economic growth for 2009 was contracted for the first time since the World War II.

Advanced economies were expected to face the most



severe downturn. According to the World Economic Outlook (IMF, October 2009), real GDP growth of Advanced Economies which had weakened to only 0.9 per cent in 2008, was expected to decelerate further into the negative growth territory i.e., (-4.0) per cent growth in 2009, whereas the US where the crisis originated, was expected to witness (-2.5) per cent growth, the Euro Area to (-4.2) per cent growth and Japan whose recovery has been rather weak, was expected to face output contraction of as much as 6.2 per cent in 2009.

While all the traditional engines of growth were in deep recession in 2009, the EMEs have also been severely hit. Yet, in most EMEs, there was a slowdown, but no recession. Illustratively, China was said to be facing a slowdown in growth from 13 per cent in 2007, to 9.0 per cent in 2008 and further to around 6.5 per cent in 2009. In our own economies, from around 9 per cent growth rate in 2007-08, there was a distinct slowdown to 6.7 per cent in 2008-09 and expectation of a further slowdown to 6.3 per cent in 2009-10. Most EMEs, especially China and India not sinking into recession was clearly symptomatic of remarkable resilience that they have achieved over years.

With the advent of the global economic crisis, the world trade decelerated from a growth of 7.2 percent in 2007 to 2.9 per cent in 2009 and as per the WEO projections, it was expected to decline by 12.2 per cent in 2009. These estimates were corroborated by the World Trade Organisation (WTO). According to their estimates, the volume of world exports could contract in 2009 by 10 per cent – which would be the largest contraction witnessed since the World War II. The International Labour Organisation (ILO) in their report titled : “Global Employment Trends” (2009) estimated that (in terms of the worst cast scenario) the number of unemployed could rise by as much as 50 million in 2009. Not surprisingly therefore, latest global economic crisis was seen three-months ago as perhaps the worst ever threat to the global peace and stability since the World War II.

In the aftermath of global economic crisis and the unprecedented contraction of world trade, the issues relating to multilateral co-operation, especially the role of The WTO in providing a stable, open and rules-based trading system backed by a forceful dispute settlement mechanism has assumed even greater significance. Indeed, the global crisis has reemphasized the virtues of relevance, credibility and smooth working of the international trading system.

Responding to the global economic crisis, some Advanced Economies e.g., the USA and even some EMEs e.g. China, have attempted to revive domestic demand through unprecedented stimulus packages. Since such packages are primarily targeted at rescuing domestic corporate entities, they have had some trade-distorting effects – for example, the so-called “Buy American” provisions in the American Recovery and Reinvestment Act, 2009. Moreover, trade finance instruments have become more costly. Despite concerted efforts by multilateral and regional development banks as well as by Advanced Economies themselves, trade finance gap of around US \$ 300 billion (WTO estimate) has emerged. Since the end-2008, some Governments have also resorted to protectionist measures. Some minor ‘tit-for-tat’ kind of skirmishes have also already taken place – for example, between US and Mexico, and between US and China. It is comforting however that the WTO members, by and large, have refrained from taking WTO-inconsistent measures, despite domestic protectionist pressures and these adverse developments have not led to a wave of competitive protectionism that prevailed in the disastrous ‘beggar-thy-neighbour’ trade fights of the 1930s.

International co-operation is widely recognized now as being critical in resolving the unprecedented global crisis of such massive proportions. In this context, the G-20, leaders have demonstrated exemplary solidarity in their London Summit (April 02,2009), and have resolved to restore confidence, growth and jobs; repair the financial system to restore lending;

strengthen financial institutions and importantly, promote global trade and investment while rejecting protectionism and building an inclusive and sustainable recovery. Infact, the G-20 members have "committed to refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing WTO inconsistent measures to stimulate exports and will not retreat into financial protectionism, particularly measures that constrain world wide capital flows, especially to developing countries".

Interestingly, WTO Director General Mr. Pascal Lamy has argued that the Doha Development Round would be a good solution to the global economic crisis in the sense that it would be "one of the most appropriate collective stimulus packages".

How realistic is this possibility, it is not clear. Short-term fire fighting seems to have taken precedence over the negotiation dynamics of the Doha Round, shifting attention away from negotiations on long term regulation and reform of international trade. Not surprisingly, in some quarters it has even been argued that a failed Doha Development Round be accepted and the international community should start looking for second best options.

To my mind, such a pessimistic prognosis is not desirable. There is an imperative need to conclude the Doha development Round successfully, even if it is at somewhat less ambitious level, than contemplated initially. The conclusion of the Doha Development Round would certainly send exceptionally strong political signal against protectionism. That would be possible only if there is willingness to learn from the past, readiness to compromise and a shared vision about a sustainable future.

## II. Global Policy Response to the Crisis

It is widely recognized that the global crisis was caused by several factors including both moral and intellectual failure in both the public and private sectors. The multiple explanations offered in the aftermath of the

crisis include those relating to macro-economic management (i.e., global current account imbalances – huge current deficits in the US and large current account deficits in Asia, especially China, excessively accommodative monetary policy in the US, and lack of emphasis on financial stability), those relating to inadequacies of the regulatory framework in the financial stability and those relating to inadequacies of the potential for market failure driven possible by vested interests which benefited from excessive leveraging in the deregulated financial environment.

The policy responses world-wide in the wake of the global crisis may be summarized into seven broad categories:

1. Reduction in policy interest rates;
2. Providing ample liquidity;
3. Closely interacting with financial intermediaries so as to restore the confidence and avoiding large-scale insolvency e.g, injecting capital, lending to financial institutions and providing blanket insurance to depositors).
4. Fiscal stimulus packages involving discretionary fiscal dispensations. According of one estimate, the combined support packages amounted to a whopping US\$ 14 trillion or around one quarter of the global GDP, comprising individual packages as follows: US (73% of GDP), UK (74% of GDP), Euro Area (18% of GDP) and China (16% of GDP).
5. Reforming prudential (and accounting) standards.
6. Significantly enhancing the lendable resources of the IMF so as to enable it to provide assistance to developing economies in distress;
7. Concerted and co-ordinated action through G-20 which included commitment to refrain from raising new barriers to investment or trade in goods and services.

### III. Policy Responses in India

The fundamental lessons from the global economic crisis are clearly evident, now:

- (a) Fiscal prudence and rectitude is critical. If fiscal deficit as a ratio of GDP is contained and debt-GDP ratio is low, the Government has the necessary elbow room for enhanced spending, cutting taxes and raising debt when necessary, so as to deal with the crisis.
- (b) Financial stability must be an integral part of public policy. Financial sector reforms must ensure the existence of uninterrupted financial transactions, acceptable level of confidence in the financial system and avoidance of excess volatility that unduly and adversely affects the normal real economic activity.

On both counts, India was favourably placed vis-à-vis several Advanced Economies. First, under the Fiscal Responsibility and Budget Management (FRBM) Act, the fiscal deficit of the Central Government had been brought down from around 8 per cent of GDP in the early 1990s to barely 2.5 per cent of GDP when the global crisis broke out. Secondly, the RBI had judiciously adopted a gradualist and calibrated approach to financial sector reform. Rather than a big-bang approach, the RBI had maintained that the financial sector reform is process, and not an event, which the global financial crisis has now vindicated. Nevertheless, given the unprecedented scale of the global crisis, the Indian authorities took a number of conventional and conventional measures with a view to contain the potential adverse effect on the Indian economy.

On the fiscal policy front, the Government of India invoked the emergency provisions of the FRBM Act seeking relaxation from the fiscal target and launched fiscal stimulus packages beginning December, 2008 which included, inter alia, additional public spending, Government guaranteed funds for infrastructure spending, cuts in indirect taxes, expanded guarantee cover for credit to micro and small enterprises, and

additional support to exporters. Even before these packages were announced, a series of other policy initiatives were taken including a farm loan waiver package, expanded safety net for the rural poor and salary increases for Government staff, leading to a significant stimulation of aggregate demand well before the onset of the crisis.

On the monetary policy front, several measures were taken with a view to augment domestic liquidity, foreign exchange availability and to sharply reduce the policy interest rates. Illustratively, during seven month period i.e., between October 2008 and April, 2009, the repo rate was reduced from 9.0 per cent to 4.75 per cent; the reverse repo rate was lowered from 7.0 per cent to 3.25 per cent; and the Cash Reserve Ratio (CRR) was reduced by cumulative 400 basis points to 5.0 per cent. In fact, the actual/potential provision of primary liquidity amounted to the order of Rs.5,60,000 crore (or roughly over 10 per cent of GDP). On the monetary policy side, the RBI also resorted to some measures which were uniquely appropriate for the domestic financial conditions. These included, for example, rupee-US dollar currency swap window for banks, refinance to apex institutions catering to small industries, exports and housing, and refinance to banks' lending to mutual funds and non-banking financial companies. Besides these, a special arrangement was made for the non-banking financial companies. Besides these, a special arrangement was made for the non-banking financial companies under stress, wherein liquidity support was provided by the RBI whereas the solvency risk was borne by the Government. In sum, the RBI synchronized the liquidity management operations with those of exchange rate management and internal debt management so as to ensure maintain appropriate levels of liquidity in the financial stability.

In respect of the financial sector reforms, India had the experience of using pro-cyclical provisioning norms and counter cyclical regulations such as higher risk weights and provisioning requirements for certain

sectors witnessing very high growth rates, even before the advent of the global crisis. These came in handy in enhancing financial stability by restoration to their original levels. In order to preserve the value of the assets affected by sudden and sharp deterioration in external conditions, banks were instructed to take action for the quick detection of weaknesses and put in place time bound restoration packages for viable accounts without resorting to ever-greeting.

#### IV Recovery and Resurgence

In response to the concerted and coordinated and coordinated policy actions among the G-20 nations, the global economy started stabilizing around the third calendar quarter of 2009 and has now begun a steady recovery out of the recession. The Managing Director of the International Monetary Fund (IMF) Mr. Strauss-Kahn has said earlier this month that "The global economy is recovering, even if its recovery is fragile" He has also said that recovery is occurring "sooner and stronger" than anticipated. According to him, "the root of crisis" was "a failing of regulation and supervision of the financial sector in the U.S." "A lot has been done, but it is not enough". The IMF has also warned that "recovery in Advanced Economics has been sluggish" given the fragility of the recovery in Advance Economies, the IMF has warned them against early exit from stimulus. According to IMF, the west faces a double-dip recession if economic stimulates packages are withdrawn too early.

The IMF has categorically admitted that it is the "Emerging Asia is leading the world back to growth". While the World Economic Outlook published by the IMF is expected to revise its October 2009 forecast of global economic growth in 2010 upwards from 3.1 percent to close to 4.0 percent, it is expected to be driven mainly by China (close to 10% growth), India around 7-8% growth), and other Asian countries, especially Indonesia and Thailand.

In sum, while there are signs of a welcome recovery from the depth of recession among Advanced Economies, the resurgence is evident only from developing Asia in general and China and India in particular.

#### V Resurgence in India: Balance Sheet of Reforms

##### 1. India never had a recession

There was only a slowdown

-from 9%+ average real GDP growth before the global economic crisis, to 6.7% growth in 2008-09

##### 2. RBI's Review released on January 28, 2010:

	2009-10		2010-11	
	Earlier	Revised	Earlier	Revised
GDP	6.0	6.9	7.7	7.9
Agriculture	-1.4	-0.9	3.7	3.5
Industry	6.3	8.4	7.3	8.1
Services	8.1	8.7	9.1	9.0
Inflation	3.0	4.4	5.8	6.1

Note : The rates of growth are in %

In my own view:-

Real GDP growth in 2009-10 assessed above is somewhat conservative.

Actually, it could be between 7 to 7.5 percent.

In sum, in India today, there is certainly a resurgence of growth – "the growth outlook has clear upside prospects", but "inflation outlook has clear upside risks."

High food price inflation entails the risk of being transmitted to non-food items through expectations driven wage-price revision and magnifying into generalized inflation,"

Hence the Monetary Policy dilemma!