

New imperatives of growth and development: India at the cross roads

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Abstract

Background/Objectives: After 1990 India adopted the path of liberalization, privatization and globalization, making it a “Breakout Nation” achieving an average growth of 7% in Gross Domestic Product (GDP). However, during the last two years, growth is showing a declining trend. The policy makers are in a quandary whether to persist with inflation targeting and Fiscal Responsibility and Budget Management (FRBM) act or be flexible with public debt, depreciate Indian rupee and provide greater fiscal incentives to spur private investment and exports. The objective of the paper is to bring out a credible policy mix, to improve growth, employment and Human Development Indicators (HDI).

Methods/Statistical Analysis: It has used data from credible official sources and analyzed them through suitable tables and graphs. A correlation between growth and development has also been established. The swan model has been used to demonstrate the demand and CAD short fall in India.

Findings: The major findings are that to mitigate demand and current account deficits there is a need to depreciate Indian rupee, bolster investment in the private and public sector and provide tax incentives to propel the “Animal Spirits” of the entrepreneurs. Further since India’s high growth is not accompanied by improvement in nutrition level of children, Maternal Mortality Rate (MMR) and extreme poverty reduction, investment in the social sector must be doubled. Quality of primary education, skilling and research initiatives have to give greater attention. Privatization of public sector banks (PSBs) will improve financial intermediation and curtails Non Performing Assets (NPAs) substantially.

Application/Improvements: The recommendations would mark a definitive departure from the current obsession with fiscal stability at the cost of growth and development.

Keywords: GDP, FRBM, HDI, Swan model, MMR, PSB, NPA.

1. Introduction

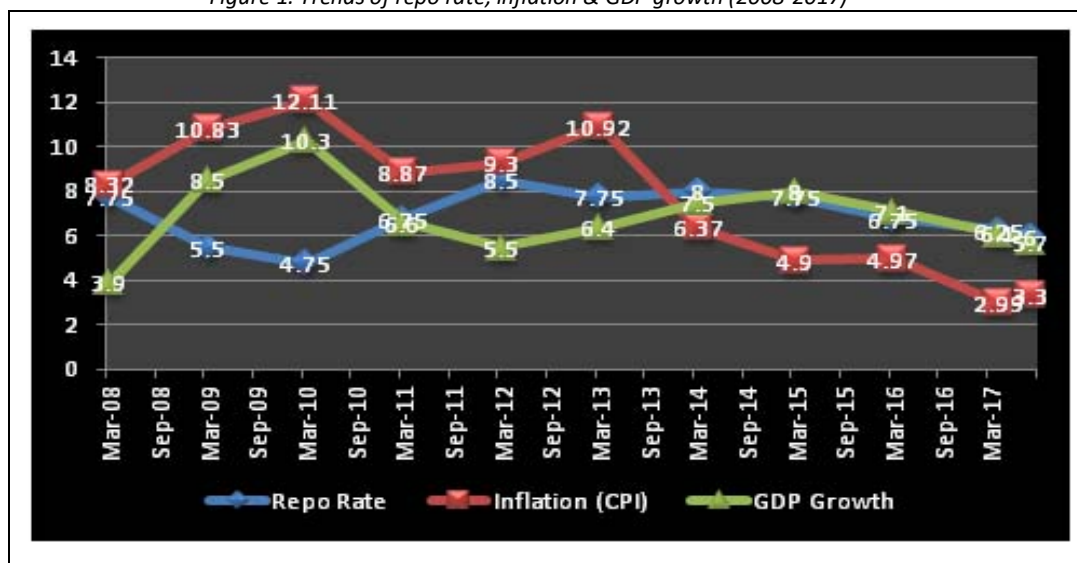
India is in the cusp of a classic dilemma today, whether to persist with inflation targeting and adhere to fiscal deficit target, or unloosen the fiscal stance, reduce its repo rate and pay greater attention to exchange rate management in order to arrive at a higher GDP growth trajectory in future. Compared to pre-liberal India, Indian economy is now far more open, more private sector oriented and much less dependent on good monsoon. While inflation remains within the glide path of $4\pm 2\%$, trade deficit around 1% of GDP and fiscal deficit is likely to hover around 3.2% of the GDP by end of the fiscal, there is justifiable concern that GDP growth has come down from a high watermark of 8% in march 2015 to around 5.7% in August 2017 of particular concern is private sector investment which has dipped from a level of 25% in 2011-12 to 20% now. India is also saddled with jobless growth. As a matter of fact, because of ill-conceived demonetization, there was increase in unemployment by 2.1 million as reported by the CMIE [1]. India is witness to improvement in credit rating by Moody and ease of doing business by the World Bank. In contrast, its poor development record shows significant stagnancy after economic liberalization. This paper attempts to capture the (a) Impact of inflation targeting and repo rate on GDP growth rate (b) Macro economic trends and growth and development

disconnect (c) Key lessons in terms of total factor productivity and the Swan model (d) FRBM act and its impact (e) Conclusion.

2. Inflation targeting, repo rate & GDP growth

During 1973-75, USA experienced high inflation with recession, due to significant spurt in oil prices, consumerism and heavy military expenditure in Vietnam. This phenomenon was called stagflation [2] who strongly advocated squeeze in money supply as the panacea to come out of it. Federal Reserve Bank Governor [3] used repo rate to slay this demon of inflation and increased it as high as 20% from erstwhile 2%. This cooled down inflation in USA to less than 5%. Volker’s is thus associated with inflation targeting through repo rate, and neatly fitted into “Tinbergen rule” [4] which advocated for one policy instrument to take care of one macroeconomic problem. Raghuram Rajan took over as the RBI Governor [5] in September 2013, he adopted inflation targeting as the single thrust area of RBI by deciding on the repo rate as inflation had mounted to 9.8%, with food inflation hovering around 14-15%. Food inflation affected the poor, and middle class seriously, who constitute 85% of the economy. Rajan also appointed the Urjit Patel committee to evolve a suitable price index to take care of food inflation. This resulted in acceptance of Consumer Price Index (CPI) (in which weight age of food items was 48%), as the policy template for both the RBI and the Government. CPI is also globally adopted as the benchmark for policy intervention. This has been the genesis for CPI to adopt by the PRI and the government, supplanting WPI, where the major weight age was for manufactured products. Happily for India, due to firmness of the RBI in linking repo rate to expected inflation in terms of CPI, global commodity trends and favorable monsoon, and a reasonable MSP (Minimum Support Price) for buffer stocking food grains, the CPI has now come down to around 1.5% during Q-4 of 2016-17, & Q-1 of 2017-18. Heartrendingly, the economic survey (2016-17) notes, that for seven consecutive quarters, CPI which is less than the glide path rates i.e. $4\% \pm 2\%$ which has been fixed as a an ideal benchmark for CPI by the Urjit Patel Committee. Both the economic survey [6] and the annual report of the RBI (2016-17) [7] have forecast that the CPI for 2017-18 would be around 3.5% - 4.5%, as the monsoon is expected to be normal and there is commodity boom in the global markets. The position during March 2008-August 2016 in respect of interrelationship between repo rate decided by the RBI, CPI and GDP growth from 2008 onwards is given below: Figure 1 that there is no perfect correlation between the repo rate, inflation and growth [8]. The repo rates were significantly slashed (2009-10) when inflation hovered over 10.8%-12.11% on the other hand; low repo rates did contribute a significant growth in GDP during this period. During 2013-14, a dip in repo rate coincided with low inflation also.

Figure 1. Trends of repo rate, inflation & GDP growth (2008-2017)



Source: RBI annual report, 2016-17 & World Bank annual report, 2016

3. Macro Economic indicators, growth & development disconnect

It was J.M. Keynes who had written in “The General Theory of Employment, Interest & Money” [9] that private investment is guided by “Animal Spirits”, where investors are not averse to risk taking. India, private sector investment over the last four years has been decreasing as represented by economic survey volume II and the RBI annual report 2016-2017. It would, therefore, be imperative to look at the major macroeconomic indicators since 2013-14 and the sectoral trends.

Table 1. Key economic indicators

Parameter	13-14	14-15	15-16	16-17	17-18
GDP	6.4	7.5	8.0	7.1	6.75
Savings	33	33	33	33	33
Capital formation	34.7	34.2	34.2	34.2	34.2
Prices (CPI)	9.5	5.9	4.9	3.5	3.75
Current account balance	-1.7	-1.3	-1.4	-0.7	1.0
Broad money (M ₃)	12.4	10.8	10.1	7.4	7
Manufacturing	5	3.8	3.0	4.1	5
Agriculture	5.6	-0.2	0.7	4.9	5
Services	11.2	11.1	9.4	5.7	9

Source: Economic survey, 2016-17, Vol-II, Government of India

Table 1 that GDP is showing a decelerating trend and savings & capital formation has remained stagnant. Besides growth in time deposits have come down, showing a reduction in lending trend from 12.4% to 7%. Manufacturing has remained stagnant, while fiscal deficit is in line with the targets fixed by the FRBM act. The silver lining is that agriculture sector is the upward swing and is now growing around 5% against an average growth of 2.5% earlier.

3.1.1. Growth and development disconnect

Figure 2 that the contribution of agricultural sector to GDP has come down from 28.5% to 15.4%. On the other hand, the percentage of population working in the rural economy has not come down appreciably. This has led to what Ragnar Nurkse called “Disguised employment” in our rural economy having 70% of population, marked by very low productivity of labour.

Figure 2. Impact of reform on growth, poverty, sector & FE reserves



Source: Economic survey, 2016-2017, Government of India

The Chinese high growth experience was based on “Lewis growth model” when they transferred a large amount of surplus labour from the agricultural sector to the manufacturing sector. This has not happened in India on the other hand, the manufacturing sector is characterized by stagnancy in terms of its contribution to GDP and employment. The proliferation of small scale sector and unorganized sector are seriously handicapped in terms of access to formal banking system, technology and economy of scale. The only sector which has contributed to employment segmentations are the construction sector, textile and IT.

The national manufacturing zone policy (2011) has really not borne fruits in terms of increasing share of manufacturing from 16% to 25% and generating additional employment of 10 million as projected. The actual employment generation has been only 0.5 million; and that too in the organized private sector. There has been hardly any employment generation in the public sector. The service sector has been India’s sunshine sector, with IT and financial services making significant impact on GDP. Social inclusion initiatives like MNREGA have brought down people below the poverty line from 45.3% in 1993-94 to 22% during 2011-12. The FE reserves, which could cater to a “Week’s import requirement can now take care of 7 months” requirement.

However, the most distressing picture is in terms of growth and development disconnect as the following Table 2.

Table 2. Growth & development disconnect

Parameter	1951-1989	1990-2016
GDP growth	3.5	7.0
Savings	16	31
Export as % of GDP	13	25
IMR (1000)	53	44
MMR (1 lakh)	260	174
Mean Year of Schooling	3.5	4.4
% Children with Malnutrition	48	46

Source: Montek Singh Ahluwalia

Quite clearly, poor average schooling, lack of adequate concern for infant & maternal mortality and children who suffer from malnutrition present a dismal development picture. The fallout of the development short fall is captured in our shortfall in achievement of Millennium Development Goals (MDG) [10].

Table 3. Millennium development goals

S. No.	Goals	India’s achievement
1	Eradication of extreme hunger and poverty	23.6% (BPL)
2	Achievement of universal primary education	Achieved
3	Promotion of gender equality and empower women	Achieved
4	Reduction of child mortality by 2/3 rd	1/3 rd
5	Improvement of maternal health by 3/4 th	1/3 rd

Source: UN millennium project goals & human development report, 2016

Table 3 shows that while access to primary education and gender equality ensured in primary education has been achieved. In fact close to 97% of boys and girls are now literate in India. There has been a significant short fall by about 50% in case of IMR and MMR with reference to MDG targets. Most disappointing has been the achievement in case of elimination of poverty where close to 270 million people are below the poverty line as per estimate [11].

3.2. Economic and social indicators of DCs & BRIC countries

A comparison of major economic indicators of developed and EMEs like the BRICS reveal the following picture.

Table 4 shows that Germany, Japan, China and Russia are the major manufacturing hubs and show current account surplus, on the other hand countries like Japan, India, Brazil are highly indebted. Cost of borrowing very high in Russia, Brazil, India and South Africa. In the Indian context what are most disturbing are cost of public borrowing and the danger of fiscal deficit breaching safe limits, leading to high price rise.

Table 4. Economic indicator: DCs & BRICS

Country	Per Capita Income	GDP Growth	Inflation	CA Deficit / Surplus	Fiscal Deficit / Surplus	Cost of Govt. Bonds
USA	53245	+2.2	2	-2.5	-3.4	2.4
Germany	45000	+2.1	1.7	+8	+0.7	0.48
Japan	37268	+1.5	0.5	+3.6	-4.5	0.7
Russia	23286	+1.8	3	+2.5	-2.1	8.1
China	13345	+6.8	1.7	+1.4	-3.9	3.7
Brazil	14145	+0.7	3.5	-0.8	-8.0	8.7
India	5663	+6.7	3.5	-1.4	-3.5	6.8
South Africa	12087	+0.7	5.3	-2.9	-3.3	9.2

Source: Human development report, 2016 & the economist

Table 5 shows that the most distressing trend for India is its unacceptably high level of MMR (174) and Children suffering from malnutrition (38.7). While developed countries like USA, Germany and China have scored more than 90% in terms in human development capability and low gender inequality barring between 7% to 20%. In case of India it is unacceptably high at 53%. Income inequality is very high in most countries except Germany and Japan where it is around 30%. India urban inequality is increasing as compared to the rural areas.

Table 5. Development indicator: DCs & BRICS

Country	HDI	GII	Income Inequality	% Below Poverty Line	MMR	Children Below Malnutrition
USA	0.920	0.203	41.1	--	14	2.1
Germany	0.926	0.066	30.1	--	6	1.3
Japan	0.903	0.116	32.1	--	5	7.1
Russia	0.804	0.271	41.6	--	25	--
China	0.738	0.164	42.2	--	27	9.4
Brazil	0.754	0.414	51.5	7.4	44	--
India	0.624	0.530	35.2	21.9	174	38.7
South Africa	0.666	0.394	63.4	53.8	138	23.9

Source: Human development report, 2016 [12]

4. Key lesson of factor productivity

One of the key lessons from the developed countries like Germany & Japan, who were devastated by the 2nd world war and emerging developed economies like China, is that they invested handsomely in quality education at the grassroots, skill improvement and research in the universities and laboratories. This has helped them to become global manufacturing hubs, with consistent trade surplus.

Prof. Robert Solow, a Nobel Laureate, highlighted the importance of factor productivity, popularly known as "Solow Residual" [13] to underline this aspect. His equation: $Q = A \times K^\alpha \times L^\beta$, where A is scale of production & level of technology, K & L are factors of production and α and β are factor productivity, has been seriously taken by these countries to invest handsome in public education and fund research programmes. It has been estimated that 70% of the average growth of around 2.5% per year noticed in the USA, is due to factor productivity. Similar has been the experience in Germany, Japan and China.

In contrast, the remarkable growth of around 7% per year in India, during the last decade is largely due to inflow of capital, foreign investment and only 30% has been contributed by improvement in factor productivity. This holds a very important lesson for India, to view high growth and human development capability in tandem, rather than being uni-dimensional in our policy approach.

4.1. The swan model

Prof. Nitin Desai, who joined the Planning Commission in 1977 as an advisor has brought out how India has become more open in the trade sector, private sector oriented and less dependent on good monsoons to ensure food security [14]. Table 6 brings out the contrasts delectably.

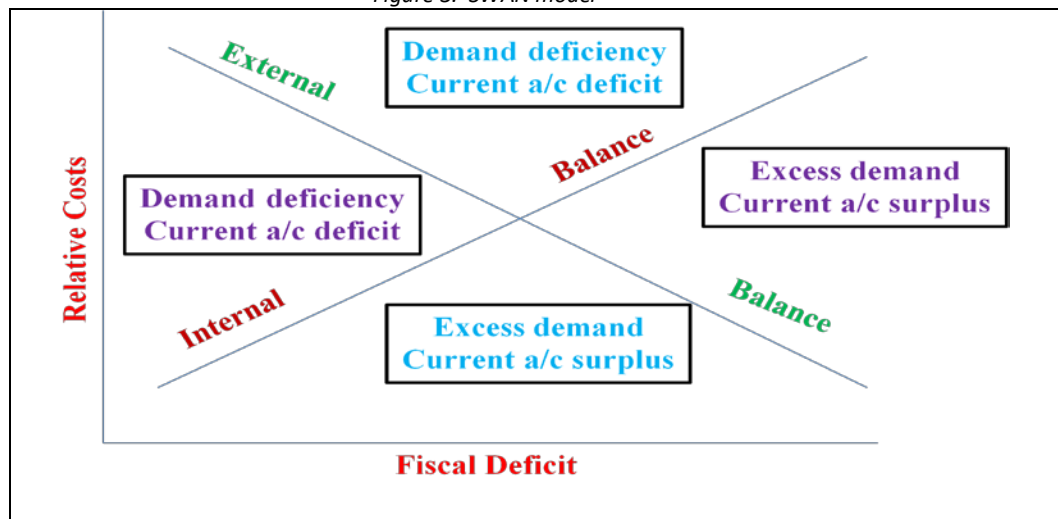
Table 6. Macro economic trends: 1977 & 2017

Parameter	1977	2017
Agriculture as % of GDP	38%	17%
Industry as % of GDP	26%	26%
Services as % of GDP	36%	57%
Export & Import as % of GDP	12%	41%
FDI & FII Inflow as % of GDP	2%	6.8%
Public Sector Investment as % GDP	9.8%	7.4%
Private Sector Investment	1.5%	11%

Source: Macroeconomics: then and now by Nitin Desai: the business standard

It would be seen from the table that dependence on agriculture and good monsoon has come down significantly from 38% to 17% in India. The most important change has been growth of services, increase in the share of the trade sector in GDP and inflow of funds from abroad significantly increasing. While the public sector has stagnated the private sector has become the new engines of growth and investment in India. In other words India has become a more open economy and globally better integrated. Prof. Desai draws upon the Swan Model to underline a future policy trajectory option for India. Figure 3 the model clearly shows that India suffers from demand deficiency and current account deficiency. The demand deficiency is largely due to lack of employment opportunity which is a function of both private and public investment as Keynes had rightly pointed out. Prof. Desai therefore suggest that instead of having a singular focus on targeting inflation and containing fiscal deficit, India should make its rupee more market responsive, provide tax incentive to bust private investment and make the economy more export friendly.

Figure 3. SWAN model



Source: Macroeconomics: then and now by Nitin Desai: the business standard

5. FRBM act & its impact

The FRBM [15] aimed to institutionalize fiscal discipline by targeting elimination of revenue deficits by 2008 and containing fiscal deficit to 3% by that time. Nine years later, the revenue deficit remains at 2.2% and fiscal deficit 3.2%, while some of the slippage in the past can be attributed to the US financial crisis (2007-09), most of it is due to profligacy in non-plan expenditure like huge borrowings and subsidies. In recent years, however, there is greater seriousness to stick to the FRBM targets. The following trends would buttress the above contention.

Table 7 shows that both in fiscal and revenue deficit there is a consistent effort to bring them down from 2013-14 to 2018-19 and make it at par with the FRBM target fixed during the budget speech of the Finance Minister. While there have been slippages but they have been marginal compared to the earlier times where the

compliance was far less. The period 2013-17 was marked by a clear government commitment to ensure fiscal discipline without giving undue attention to growth which can generate high inflation. The N.K. Singh Committee (2017) to review the FRBM targets has come up with a recommendation to reduce fiscal deficit of the Centre and States, which is around 70% now, to 60% by 2022-23 (40% for the Centre and 20% of the States). This is going to an onerous challenge, given our computation to double public investment on infrastructure and social sector on one hand and maintain fiscal discipline on the other. It would be wise to be fiscally prudent rather than being inflexible.

Table 7. Fiscal & revenue deficit trends

Year	Fiscal Deficit	Revenue Deficit
2013-14	4.5	3.2
2014-15	4.0	2.9
2015-16	3.9	2.9
2016-17	3.6	2.6
2017-18	3.2	2.4
2018-19	3	2.2

Source: Economic survey, 2016-17, Vol-II, Government of India

6. Conclusion

As the foregoing would reveal inflation targeting and FRBM act can't alone drive India's future fiscal policy. Indian rupee is overvalued by around 7% in the external market. There is thus a strong case for devaluing the rupee by around 10%, so that our exports become competitive as China did recently. Tax reduction and higher depreciation percentage for P&M are required to encourage the private sector to boost their investment. The public sector investment must increase for 7.5% to 15%. For doing so, the fiscal deficit target of 3% next year would have to be slightly breached, say to around 3.2%. Rationalisation of IT Rules in sync with best global practices and better tax compliance would increase our Tax / GDP ratio from the present 12% level by the RBI to 16%. The fiscal initiatives must be complemented by corresponding reduction in the repo rates so that growth of credit moves up from 7% to 12% achieved in 2012-13. The policy initiatives have to be multipronged, instead of harping only on target fiscal deficit targets and containing inflation. Besides, there is a need to look at big ticket reforms like privatisation of PSBs, which is contributing heavily to the lack of buoyancy in investment. Recapitalisation would only shift the goal post of inefficiency and accountability of the PSBs. Labour market rigidity has to be transcended with appropriate Central Law, if the footprint of organised sector is to be significantly increased for India to become a global manufacturing hub. The growth of financial aggregates and start-ups are encouraging signals. But most critical to India's long term growth would be its improvement in HDI, for which needs investment in quality education, skilling and research and development foot print which are inescapable. The present imbalance between growth and human development has to be transcended.

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The Publication fee is defrayed by Indian Society for Education and Environment (www.iseeadyar.org)

Cite this article as:

Prof. (Dr.) S.N. Misra, Prof. Manvinder Singh, Mr. Sanjaya Ku. Ghadai. New imperatives of growth and development: India at the cross roads. *Indian Journal of Economics and Development*. Vol 6 (1), January 2018.