Chapter VIII Summary And Conclusions

8.1 We have attempted in the preceding seven chapters to examine the issues pertaining to macroeconomic policies in India. We began by stating that Analysis of Indian macroeconomic policies is necessary and important in as much as it is concerned with the question of internal and external viability & health of the Indian economy. Internal viability could be assessed in terms of resource mobilization, price stability, a good agricultural and industrial performance, self sustained growth at the aggregate level, the resilience and adaptability of the economy against the internal shocks like agricultural droughts etc. The external economic viability could be appraised against the economy's capacity to sustain a higher growth rate of exports over time and the capacity to earn more foreign exchange to import more as well as to pay for debt service obligations. Keeping this theme of economic viability of Indian economy, the study initially reviewed the state of the Indian economy by examining the behaviour of major sectors like Agriculture and Industry and that of macroeconomic variables like savings, capital formation, inflation etc. and then sketched a chronological survey of macroeconomic policies followed almost over last four decades. The study identified major achievements and failures of the Indian economy and then it described, the macroeconomic policies adopted; It also examined their appropriability in terms of multiple objectives of planned economic development like accelerated growth, mobilization of resources, price stability and healthy balance of payments. Our overall assessment of Indian economy and macroeconomic policies led to following observations:

The most impressive achievements have been in the field of agriculture development, in the rising rate of domestic savings, in the creation of a highly diversified industrial base and in achieving a higher growth rate of 5 percent compared to sluggish growth evident up to mid-seventies.

Agricultural production has moved to a higher growth path in 1980s compared to the 1970s, from 2 percent to a little more than 3 percent. Expansion of irrigation has made agricultural growth less vulnerable to the vagaries of monsoons. Dependence on large scale imports of food grains has been almost eliminated. However, the agricultural growth rate is still short of 4 percent target growth of agricultural production in the seventh five year plan. This might seem achievable in view of the structural and institutional changes which have taken place in agriculture recently.

In the industrial field, a substantial public sector presence has been created, laying the foundation for a mixed economy. A high degree of self reliance has been achieved in the sense that a highly diversified industrial base has been created, catering to the domestic needs of the economy in a very wide variety of products. The enterprenurial base of the economy has also been widened greatly, with the emergence of a number of new large and medium scale industrial houses and a profusion of small-scale entrepreneurs. However, industrial growth has not been as rapid as was expected. After a promising early period in fifties and early sixties, industrial growth slowed down considerably, and from 1964-65 to 1975-76 the index of industrial production showed a growth rate of only 4 percent per year. There is evidence of a gradual acceleration after the mid-seventies, though with considerable year-to-year fluctuations. During 1981-89, it showed an average growth rate of around 7 percent, but it still falls short of what is needed to take the economy beyond the current 5 percent growth of GDP.

Another major short coming in India's industrial sector is its lack of international competitiveness and consequent poor export performance. Export performance is obviously important in a situation in which the continued growth and modernization of the economy requires a substantial inflow of imported capital goods and other inputs into production. The industrial sector, which absorbs a large percentage of total resources available to the economy, must be able to earn the foreign exchange it needs from exports. This has not yet happened to the extent needed, and one of the major constraints is clearly lack of competitiveness in terms of both cost and quality.

Furthermore, the gross domestic savings rate which was 17 percent in 1970-71 had increased to around 24 percent by 1980s. There is, however, certainly the need and scope for further increasing the rate of savings and thereby also the rate of investment. But the levels achieved and their evident sustainability reflect on important structural transformation in the economy.

Inflation in Indian economy has been quite moderate by international standards; The macroeconomic policies had strong systematic bias in minimising inflationary trends and in number of years, monetary and fiscal policies hade been successful in reducing inflation; however, inflation has occassionally come in fits and starts, associated both with bad harvests and import price rises. This has the undesirable consequence of generating inflationary expectations which could cause further higher rates of inflation.

It hardly needs to be stressed that this macroeconomic performance of the Indian economy could, by and large, be attributed to the specific stabilization policies followed and in this context, the behaviour of policy variables assumes greater significance. In Chapter 4,5 and 6, we took up several issues of monetary policy, fiscal policy and exchange rate policy in India respectively. The examination of those issues and our analysis yield following conclusions on each of those policies studied:

8.2 Monetary Policy

In the context of Indian economy, it is found that there is a long run proportionality between money stock and prices. This is not to suggest that inflation in India is strictly a monetary phenomenon; however, it can hardly be denied that influence of money stock on prices is significant. This result got strengthened in view of our empirical estimates of money stock and money income. The empirical evidence furnished (in 4.10) strongly indicated that variations in money stock are statistically significant in explaining 95 to 96 percent variations in money income in India. Since the real income or real output is usually determined by real structural factors, a strong statistically significant relationship between money and money income (product of price and output) clearly imply that money affects the price level. This result brought out the importance of the role of monetary policy in India. It strongly suggests that an appropriate monetary policy has a positive role to play in achieving price stability. This is far more important in view of the

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fact that higher inflation rates are accompanied by greater variability of inflation rates and this often imposes welfare costs on the individual decision making units. Our analysis of data on Asian countries confirmed our a priori expectation that the variability(unpredictability) of inflation becomes more pronounced with higher rates of inflation; this positive association between mean rates of inflation($\bar{X}$) and its variability($\sigma\bar{X}$) has been found to be stable across each country and each period. This has the implication that choosing an inflationary policy might carry the cost of a more variable inflation. All these strongly suggest the necessity of a cautious monetary policy or monetary management. This, however, requires stability of demand for money and stability of money multiplier over the time horizon of the policy. Our empirical study on these issues produced following findings :

i) The demand for money in India is highly stable.

ii) The measured real income is a major determinant of demand for money in India.

iii) The income elasticity of demand for money is near unity for M_1 and it is around two for M_3!

iv) The value of money multiplier is stable over a period of 4 or 5 years; The variations in reserve money account for large part of variations in money stock; this implies that Reserve bank of India can control the money stock by controlling the reserve money within narrow limits; and that money multiplier model is a good guide to monetary policy and it has some operational significance.

In addition to this, the conduct and formulation of monetary policy requires the choice of an appropriate indicator and target of monetary policy. This study argues that it is the real value of money stock which indicates correctly the appropriate stance of monetary policy. On this count, the direction of monetary policy in terms of nominal magnitudes is highly misleading. In inflationary situations, as they prevail now, assessment of monetary policy in nominal terms is not a correct approach. On the basis of empirical criteria of controllability, variability, closeness and stability with goal variables and exogeneity, the major conclusion was that it is narrow money M_1 rather than broad concept of money M_3 which is more suitable variable for monetary targetting. Furthermore, our analysis (in 4.14) suggests the need for considering the quality of money supply expansion besides the quantity aspect. It was shown that under the apprehensions of possible inflationary rise in prices, if anticipated increased contribution of foreign exchange assets is compensated by curtailing liquidity to the private sector in order to keep adequate monetary budget, it could lead to serious loss of output. It was also brought out that a proper composition of allocation of credit would require and should ensure adequate flow of credit to Agriculture and non-agricultural sectors. This should be in alignment with the anticipated growth of agricultural and non-agricultural sectors. A bumper food grains crop with moderate growth in non-agricultural sector necessitates larger credit flow to agriculture sector but credit allocation will have to be adjusted in view of higher than average growth rates of agriculture and non-agricultural sectors if the policy objective is to minimize output losses of agriculture and non agricultural sectors. Furthermore, of all the factors affecting money supply in India, our analysis clearly indicated the dominance of the role of net RBI credit to government. This suggests that the government's borrowing requirement is met in substantial measure by banking system in general and Reserve Bank in particular. Since the Reserve Bank cannot control government deficits and has to lend to cover them, monetary policy is in effect largely concerned with making room for the government in reserve money expansion. This only means that monetary arrangements in India severely constrain the scope for a monetary policy that is independent of the government budget.

8.3 Fiscal Policy :

Besides monetary policy, we examined some relevant issues pertaining to Fiscal policy in India; our observations and empirical findings are following :

i) A noteworthy feature of Indian economy is the deterioration in public finances which is serious enough to have made the financing of the public sector outlays in the recent plans (both 7th plan and 8th plan) extremely difficult and uncertain. The budgetary deficit, the consolidated government and public sector borrowing requirement, and net RBI credit to the government have all increased in recent years as a proportion of GNP.

With respect to mobilization of resources, though tax revenues have increased, the share of direct taxes is quite small and this share has remained more or less constant. The major contribution to tax revenue has come from indirect taxes and its share has been found to have increased from 4 percent in 1950-51 to 16 percent in 1987-88. However, there is found to be evasion of indirect taxes alongwith direct taxes. The indirect tax structure with large number of specific taxes has become exceedingly complicated and inefficient. On the other hand, though non-tax revenues have risen, they are found making an inadequate contribution. The outstanding problem here is found to be low profitability of public sector enterprises. The overall gross rate of return oncapital employed in public sector enterprises has been found to be around 14 percent. Excluding the highly profitable oil sector, however, the return has been only 5 percent (and would be considerably lower on an inflation-accounting basis).

The share of government savings in total public savings has been found to have declined from 63 percent in 1975-76 to 26 percent in 1988-89. This is attributable to a rapid growth in current government expenditure. The real problem has been the outpacing of current receipts by current expenditures; it was found that the main elements fuelling the growth of current expenditures have been subsidies, interest payments and Federal grants to states. Subsidies (of which 70 percent relate to food, fertilizers and exports) have grown rapidly. Central government subsidies have grown from 0.7 percent of GDP in 1973-74 to around 3 percent of GDP in 1988-89. Growing export subsidies represent an attempt at partial redressal of export profitability. In the case of food, it seems to be a political constraint that procurement prices cannot be reduced even if there is a bumper crop. There are similar political difficulties in raising the issue prices of fertilizers to keepup with the rising cost of inputs. There are many other subsidies representing an attempt to buy off various pressure groups. Furthermore, the government interest payments have also grown rapidly as a proportion of GDP from about 1.7 percent in 1975-76 to about 3.8 percent in 1988-89. We also found that federal grants from the centre to states have been steadily growing; the states have been able to secure larger shares of taxes collected by the centre by showing bigger deficits. This had reduced the tax effort of the states and is one reason for the worsening financial position of the centre which now regularly has a deficit balance on both current and capital account.

ii) The most disturbing aspect was found to be not only that of growth of substantial budgetary deficits but that of occurrence of deficit on revenue account. Till the end of the fifth plan period the surplus in revenue account had always come in handy to reduce the deficit in the capital account in varying proportions. However, this compensatory role of revenue account by VIth and VIIth plans has totally vanished; rather it has become complementary to capital deficit. The deficit on revenue account has the implication that the union government is unable to sustain the ordinary business of the nation; it is an index of inadequate tax policy or extravagance in public expenditure on consumption.

iii) Furthermore, our examination of the behaviour of government deficit during the business cycles (in Section 5.5) has brought out clearly that over the years, the government deficit has not always moved in a stabilizing manner. In number of years, the deficit as well as real government expenditure has moved procyclically and both seemed to have precipitated either a recession or an expansion period. It was found that in number of years, deficit has not acted as powerfully as one would expect to constrain expansion and to stimulate economic activity during recession period. This implies the need for sufficient short term flexibility in government fiscal policy which is required to offset both demand and supply shocks.

iv) Our attempt to estimate the possible relationship between fiscal policy and monetary policy brought out clearly the dominant influence budgetary operations has on money stock; our results lend credence to the view that monetary growth in India has largely been a by product of expansionary fiscal policies. In our selected sample period and also in other sub periods, it was conclusively found that the variations in reserve money and money stock variables could easily be accounted for by variations in budgetary deficits and government expenditure. A much stronger relationship was found between government expenditure and monetary policy variables; the evidence was indicative of the fact that the compulsions on RBI to finance the budgetary gaps could obviously be attributable to ever increasing government expenditure.

8.4 Exchange Rate Policy

We attempted to analyse the adverse changes in the international economic climate and the pressures on the Indian economy to adjust to these developments with a view to arriving at a judgement on the feasibility of an autonomous non-dependent path of development in India. We argued that countries in the early stages of development will need resources from abroad to accelerate economic growth. External sources supplement domestic savings to achieve a higher level of investment. However, it is equally true that these external resources need to be made available on terms and conditions which will enable the recipient countries to repay the foreign liabilities over a period of time. We explicitly pointed out that the strategy of economic growth adopted by the recipient countries must incorporate this compulsion to repay the foreign obligations besides providing a sound base for faster growth. Against this background, we found that India's performance had been quite disappointing. This failure was found to be attributable to both internal and external factors. In our view, the domestic factors which constrained India's export performance were the costs of production, the pressure of domestic demand and the infrastructural or sectoral supply bottlenecks which, coupled with non-price factors such as quality, have adversely affected the competitiveness of our exports. The external constraints ailing Indian exports were found to be the increasing incidence of protectionism in the form of escalated tariff structure and a range of unquantifiable nontariff barriers, limited market access, deterioration in terms of trade and decleration of the growth in world import demand. In addition to this, we also observed that India's balance of payments came under a severe strain in the seventies as a result of the two oil shocks. The Indian economy adjusted to the first oil shock rather quickly due to a larger inflow of external resources, a dramatic increase in net invisibles and a phenomenal growth in remittances. The policy response of the authorities to the crisis was excessively concerned with correcting the payments deficit. However, the adjustment process had turned out to be much more difficult, in the early 1980's following 2nd round of oil price increases. This was partly due to the fact that the factors which had a favourable influence on the balance of payments the first time around waned in their impact. Besides, there was a substantial squeeze on foreign aid programs which led to an increasing reliance on expensive commercial borrowing in international capital markets. There was also found a sharp and continuous decline in net invisibles and a marked decleration in the growth in remittances. In the entire period of 1980's, India had faced severe balance of payments difficulties giving rise to large and growing external trade deficit as well as to mounting external debt and debt service burden. With all these, the magnitude of financing required, for this period, had been found of a much larger order and, given the poor response of concessional assistance, we had drawn down our foreign exchange reserves and had also turned to IMF resources as well as to borrowings on commercial terms. Use of Fund resources contributed to a substantial extent to the financing of the current account deficit during 1980-81 to 1983-84. For more recent period, Indian economy has contracted substantial commercial borrowings.

This growing commercial borrowings seem to be changing substantially the external debt profile and the cost of debt. The evidence furnished in this study indicate strongly that Indian economy is already heading towards a debt trap, in the sense that a large sum of borrowings will have to take place at present to service the debt and to finance rising level of imports.

In view of the critical need for accelerating the growth of exports, we found that the policy induced depreciation has the desirable effect of increasing real exports. There is a definite positive role which depreciation of the Indian rupee can play in augmenting our real exports. However, for achieving continuous and sustained exports capability and a sound external economic viability, reliance on the exchange rate instrument alone as a means of improving current deficits is unlikely to prove successful. It is needed that the adverse impact of both external and internal constraining factors on our exports identified earlier, be minimised as far as possible.

8.5 Conclusion

On the basis of our examination of the issues pertaining to macroeconomic policies in India, we reached the following conclusions :

1) The price stability must be the foremost objective and our stabilization policies must have a strong systematic bias in minimizing inflationary pressures in the economy.

2) Monetary policy has a positive role to play in affecting and stabilising money income as well as stabilising rate of inflation in India. With a reasonably stable demand function for money, money has an important and useful role to play in the dynamics of inflation.

3) The appropriate conduct of monetary policy requires the adoption of the method of monetary targetting in India. Monetary targetting is feasible because there is a reasonable degree of association between reserve money and aggregate money stock.

4) Of all the possible variables for monetary targetting the narrow money, M_1, is the most appropriate monetary target variable. Reserve bank of India must announce and pursue monetary targets in terms of M_1 only.

5) A certain degree of coordination between the government and the Reserve Bank is extremely essential so that passive monetary accomodation by RBI is avoided.

6) In view of rapidly rising expenditure claims and growing appreciation of the destabilizing potential of large fiscal deficits, the government expenditure should be streamlined considerably and if possible, there should be government expenditure targetting on the basis of proper assessment of the proposed outlays and allocation of funds according to accepted priorities.

7) At the policy level, there must be systematic efforts to simplify both the tax structure and tax laws in order to encourage voluntary compliance and to ease the task of administration. This is necessary to increase tax to GDP ratio. For better performance of public sector enterprises (PSEs), achievement of greater productivity and cost consciousness in the operational environments of PSEs must be injected.

8) There is a need for sufficient short-term flexibility in government fiscal policy to offset both the demand and supply shocks. There is some merit in following and adopting an anti-cyclical fiscal policy over a short time horizon.

9) The correction of the fiscal imbalance is central to any viable development for the short or medium term. What requires is to contain the growth in non-development expenditures. There is a case for containing of defence expenditure in view of our improved relations with our neighbours. In other areas of public activity wasteful expenditure need to be controlled by inculcating a sense of austerity and greater attention to cost effectiveness in expenditure control mechanisms. The subsidy burden both in the central and state budgets needs to be controlled mainly by ensuring that the anti-poverty subsidies are tightly targetted at the poor and promotional subsidies are carefully justified in

terms of results. The rising burden on interest payments in the budget can only be contained by re-examining the pattern of budgetary financing and ensuring that revenue expenditures as also capital expenditures of non-remunerative kind are fully covered by revenue receipts.

10) At the external front, in order to tackle the problems of larger deficits and growing debt burden, export growth must be maintained and the option of reducing imports has to be exercised for those items for which import substitutes are available or can easily be developed. A degree of prudence in imports is required and is of utmost significance.

11) A gradual process of policy induced depreciation in a phased manner will have beneficial effects on real exports of Indian economy; however, sole reliance on this alternative could prove to be counter productive.

12) Balance of payments management also requires that close attention be paid to the management of the capital account. Increasingly the pressure on the balance of payments arises from the increase in the absolute burden of debt service. The ultimate correction for this is, of course, a substantial improvement in the current account that reduces the need for high cost borrowings. To the

extent possible, the structure of our external liabilities must be managed by special efforts to maximise the use of concessional assistance and careful and prudent policies towards commercial borrowings in all forms.

13) Last but not the least, An objective review of our economic policies and programmes must be undertaken to reorient the content of our economic growth to make it broadly consistent with our domestic savings and export potential and, above all, the basic needs of the people. If adequate and timely adjustments are not initiated now, the possibility of more painful adjustments being forced on us in the future, similar to the Latin American type, cannot be ruled out.