

A macro economic analysis of india



**ASSIGN
BUSTER**

The Indian Economy is the eleventh largest economy in the world by nominal GDP and the fourth largest by purchasing power parity (PPP). Following the strong economic reforms the country began to develop at a fast-paced economic growth, as free market principles were initiated in 1990 for international competition and foreign investment. Economists predict that by 2020, India will be among the leading economies of the world. An economy that was characterised by extensive regulation and protectionism in pre-liberalisation era (Pre-1991), India as a country has moved toward a market-based economy and is fairing quite strongly.

The Indian economy at this point is still a small economy as its contribution to the global trade is still very small (1. 5%). Past decade has seen India grow at a rapid pace and within the last 5-6 years, India has increased its contribution from 1. 1% to 1. 5% and the trend is expected to continue. As quoted by many economists, one of the major factors that contribute to this success story has been the demographic dividend whereby 50% of the population is below the age of 25 and about 65% hovers below 35 years of age.

Along with the continued growth Indian economy is also facing its share of problems on the macro-economic level.

We as a group have tried to analyse the macro-economic indicators of India to find the pressing issues that India is currently facing and the possible solutions to the problems. Our approach has been research centric and analytic in nature.

MACRO-ECONOMIC INDICATORS

Macroeconomic Indicators

Our analysis has been based on the study of following Macro-economic indicators.

Gross Domestic Product

Unemployment

Fiscal Policy

Monetary Policy

Exchange Ratio

Gross Domestic Product

The GDP growth rate for India has been consistently positive from 2003 onwards (Exhibit 1) which indicates a booming economy. We also find that the Indian economy has been quite sturdy and it abated the recessionary pressures quite well. If we analyse the Q-o-Q growth rate from 2008 onwards, we find that even though India did indeed see a slowdown but the recession never really occurred in India (Exhibit 2).

The economy seems to be back on track with rising GDP growth rate in the year 2010.

If we classify the GDP growth sector wise (Exhibit 3) then we find that over the last decade the Services sector has been the major contributor. Though

the Agriculture sector employs more than 50% of the employed people, its contribution toward GDP has been hovering in the 15% bracket.

In fact the contribution from the Agriculture sector has been dipping down and it is one of the challenges that Indian economy face.

Unemployment

The unemployment rate in India has been on the higher side. The problem is primarily attributed to structural issues and both – rising population and the inefficiencies of the labour market are concerns of the economy. Also there are seasonal unemployment trends in India. The economy absorbs more than 50% of employment in the agriculture sector which is seasonal by nature. If we consider the other sectors then level of education and vocational training are significant issues.

Fiscal Policy

The Five year plans are an important indicator of government's fiscal policy and the direction ahead for the growth of the country. This is the reason we have started the analysis by doing a study of the 11th Five year plan.

11th Five year plan (2007 – 12)

It was developed in the context of four important dimensions:

Quality of life

Generation of productive employment

Regional balance and

Self-reliance.

Key areas of focus –

Income & Poverty in India:

Accelerate growth rate of GDP from 8% to 10% and then maintain at 10% in the 12th Plan in order to double per capita income by 2016 – 17.

Increase agricultural GDP growth rate to 4% per Year to ensure a broader spread of benefits

Create 70 million new work opportunities.

Reduce educated unemployment to below 5%.

Raise real wage rate of unskilled workers by 20 percent.

Infrastructure:

Ensure Electricity connection to all villages and BPL households by 2009 and round – the – clock power by the end of the Plan.

Ensure all – weather road connection to all habitation with population 1000 and above (500 in hilly and tribal areas) by 2009, and ensure coverage of all significant habitation by 2015.

Connect every village by telephone by November 2007 and provide broadband connectivity to all villages by 2012.

Provide homestead sites to all by 2012 and step up the pace of house construction for rural poor to cover all the poor by 2016 – 17.

The other major areas of focus are education, health, woman and children, environment.

Fiscal Policy: Trend and Implications

In order to minimize the impact of the global slowdown on the Indian economy, the Government introduced fiscal expansionary measures in the 2008-09 and 2009-10. The aim was to enhance public expenditure so as to boost demand and spur the process of development and economic revival. This could be seen with the Indian economy recording a GDP growth rate of 7.4 percent during the fiscal year 2009 – 10. The government decreased indirect taxes in order to insulate the vulnerable sections of the economy from the impact of economic slowdown. This resulted in reduced revenue receipts. The increased spending against reduced revenue receipts has resulted in increase of fiscal deficit to 6.8 %. The gross tax to GDP ratio decreased from 12% to 10.9% and 10.3% in 2008 – 09 and 2009 – 10. The total expenditure to GDP ratio increased from 14.4% in 2007 – 08 to 15.9% and 16.6% in 2008-09 to 2009-10.

Post July 09 the focus was shifted to the path of fiscal consolidation with emphasis on structural fiscal reforms and prudent fiscal management with improvement in the economic situation. Without putting at risk the revival process, the Government is looking at exit strategies with improvement in economic conditions. The fiscal budget of 2010 – 11 has been presented against this backdrop. Accordingly fiscal deficit in 2010-11 has been reduced to 5.5 per cent of GDP. The gross tax revenue is increased by .4% (10.8% for 2010-11) and the total expenditure is reduced by .6% (16% for 2010-11). Also the non-plan expenditure as percentage of GDP has been reduced from

11. 3 per cent in 2009-10 to 10. 6 per cent in 2010-11. At the same time, adequate resources for plan expenditure have been provided at 5. 4 per cent of GDP in 2010-11 as against 5. 3 per cent in 2009-10. The correction in composition of expenditure would translate into deployment of borrowed resources largely for plan expenditure (97. 8 per cent in BE 2010-11 against 81. 1% in 2009-10). Also it is estimated that subsidy expenditure as percentage of GDP would decline from 2. 1 per cent in 2009-10 to 1. 7 per cent in 2010-11.

Greater emphasis has been laid on increasing revenue. Direct tax code has been introduced with widened tax slabs, reducing the burden on the lower income groups but has also resulted in increased revenue due to the Laffer curve principle (Exhibit 5). The policy for indirect taxes in recent years has been to achieve fiscal consolidation through an improvement in the tax-GDP ratio. This is sought to be achieved through the widening of tax base and removal of exemptions coupled with moderation in the rates of tax. The revenue from central excise duty is set to increase due to increase in standard rate from 8% to 10%. Steps are being taken to move to a comprehensive Goods and Services Tax (GST) both at the Centre and in the States. By addressing the problems of cascading and double taxation, this key reform in the realm of indirect taxation is expected to contribute significantly to efficiency and growth in the economy which, in turn, would augment the buoyancy of tax collections.

Though the revenue base has not yet increased to the level of 2007-08, still, by doing expenditure reforms and with the help of disinvestment proceeds, the Government is able to bring down the fiscal deficit.

The government through fiscal policy has provided stimulus to boost economic growth during slowdown. Once the growth has been restored has shifted its focus to fiscal consolidation.

MONETARY POLICY

An analysis of the Monetary Policy of India over the past 3 years can be done as an analysis of 3 different phases (Exhibit 6).

Pre Global Slowdown: Inflation is high and RBI has been increasing all the three rates

During Global Slowdown: Inflation is still high and RBI has decreased the three rates drastically

Post Global Slowdown: RBI is increasing the rates gradually and trying to curb the inflation through its monetary measures.

The monetary policy is controlled by Reserve Bank of India (RBI). The primary focus of the policy makers has been to maintain a balance between the growth of the economy and the inflation.

We have tried to understand the various measures of RBI by applying the Complete Keynesian Model. Another important concept which has helped us in our understanding is the Philips Curve which suggests that the boom in the economy and the inflation are positively correlated. The measures to increase the unemployment also tend to increase the inflation in the economy.

So we find that by increasing the money supply, though the production increases, inflation also increases and vice versa.

Looking at the inflation chart (Exhibit 7) we find the rationale of RBI's monetary policy over the last three years.

In order to counter the inflation, RBI increased the rates in the early 2008 but as the global slowdown set in, the focus became the growth of the economy and hence the rates were decreased drastically (Exhibit 6). As the global economy is recovering, they are now increasing the rates gradually trying to maintain the balance of growth and the inflation.

Exchange Rate and India

Exchange rate stability is an important indicator of a country's economic strength. Consistent fall or fluctuation in exchange rate adversely affects the balance of payments of a country. India was under fixed exchange rate regime till March 1992. The exchange rate of the Rupee was determined and adjusted by the Central Bank (Reserve Bank of India). The Rupee was adjusted to a basket of currencies, comprising of currencies of important trade partners of India like US, Britain, Japan etc. The exchange rate was determined by the government and enforced by pegging operations (intervention in the currency market) and exchange controls by the central bank.

Today India is under managed float (dirty float) regime. Exchange rate is determined by demand and supply of currency for trade and international investments in the country, both FDI and FII. A drastic appreciation or depreciation of the rupee is not desirable. An appreciation in the value of

rupee will make our exports less competitive in the global market hence reducing GDP. Depreciation in the value of rupee will result in increased import spending especially for price elastic goods like oil. Hence RBI intervenes when required by buying and selling foreign exchange, to protect the economy from the dangers of volatile foreign capital and sudden depletion of reserves.

ISSUES

Foreign portfolio investment – A Boon or a Bane

Existing studies reveals that the huge surge in international capital flows since early 1990s has created unprecedented opportunities for the developing countries like India to achieve accelerated economic growth. Since the introduction of the reform process in the early 1990s, India has witnessed a significant increase in capital inflows. The size of net capital inflows to India increased from US \$ 7. 1 billion in 1990-91 to US \$ 108. 0 billion in 2007-08. Today, India has one of the highest net capital inflows among the EMEs of Asia.

India embarked on a gradual shift towards capital account convertibility with the launch of the reforms in the early 1990s. Although foreign natural persons – except NRIs – were prohibited from investing in financial assets, such investments were permitted by FIIs and Overseas Corporate Bodies (OCBs) with suitable restrictions. In February, 2000, the FII regulations were amended to permit foreign corporates and high net worth individuals to also invest as sub-accounts of Securities and Exchange Board of India (SEBI)-registered FIIs. FIIs were also permitted to seek SEBI registration in respect of sub-accounts for their clients under the regulations.

Various supply and demand factors have made investing via institutions a rapidly growing sector in many developed countries. A healthy financial system is critical if growing economy is to attract foreign investment. At the heart of financial system is the banking system. To prevent catastrophes from happening countries like India need to take steps to ensure that the banking system is adequately capitalized and regulatory regime of banking supervision is strong and well regulated.

FII – The Boon

Enhanced flows of equity capital

Trends categorically indicate how FII's have always sought out for equity compared to debt. FII's accentuate the trend of preference of non-debt creating foreign inflows over foreign debt. FII's can help in compressing the yield-differential between equity and bonds and improve corporate capital structures.

“

In accordance with the existing savings-investment gap of around 1.6 per cent, FII inflows can also contribute in bridging the investment gap so that sustained high GDP growth rate can be achieved.

“

Managing uncertainty and controlling risks

FII's have a solid history of making the market more competitive. This can be corroborated by the fact that they promote financial innovation. They develop hedge funds and because of this, they contribute to development of zero coupon bonds and index futures.

“

Furthermore, a variety of FIIs with a variety of risk-return preferences also help in dampening volatility.

“

FII – The Bane

The main danger posed by large and volatile capital inflows is that they may destabilize macroeconomic management. As evident, the intensified pressures due to large and volatile capital flows in India in the recent period in an atmosphere of global uncertainties has posed new challenges for monetary and exchange rate management.

Hot Money

FII inflows are popularly described as “ hot money”, because of the herding behaviour and potential for large capital outflows.

With performance-related fees for fund managers, and performance judged on the basis of how other funds are doing, there is great incentive to suffer the consequences of being wrong when everyone is wrong, rather than taking the risk of being wrong when some others are right. The incentive structure highlights the danger of a contrarian bet going wrong and makes it much more severe than performing badly along with most others in the market. It not only leads to reliance on the same information as others but also reduces the planning horizon to a relatively short one. Value at Risk models followed by FIIs may destabilize markets by leading to simultaneous sale by various FIIs, as observed in Russia and Long Term Capital Management 1998 (LTCM) crisis.

Carry Trade

India is one of the most attractive destination for FIIs to land for the simple reason that India is still offering higher interest rates at a time when the interest in USA have fallen down to 0%. The probability of the FII moving out at the first hint of any crisis or availability of better returns elsewhere is extremely high.

A case in consideration is the year 2008-09.

As is evident from the graph (Exhibit 9), there was huge FII outflow from the Indian economy especially during the global slowdown. The market index had crashed due to this and the supply of money with the bank had crashed. This shows how FIIs can form a bubble economy.

Inflationary Issues

Huge amounts of FII fund inflow into the country creates a lot of demand for rupee, and the RBI pumps the amount of Rupee in the market as a result of demand created. This excess liquidity in turns leads to increase in prices ultimately leading to increased inflation as per the Mundell Fleming framework.

Adverse impact on Exports

FII flows leading to appreciation of the currency may lead to the exports industry becoming uncompetitive due to the appreciation of the rupee. The rupee appreciated by a fairly hefty 7% between early September and the second week of October. That is bad news for exporters who find the rupee prices of their products translating into higher dollar prices (making them less competitive in the process) and dollar profits fetching smaller rupee

profits. In August, imports grew faster than exports at 32. 2 per cent, amounting to \$29. 7 billion. The trade deficit ballooned to \$13 billion and in a few months could reach \$135 billion for the entire fiscal year. The current account deficit could be 4 per cent of the GDP, which may prove to be unsustainable.

RBI's DILEMMA

In order to increase the GDP growth rate and keep it at a figure over 8%, the Government pumped a lot of money into the economy, which led to increasing liquidity and subsequently led to inflation. Now, RBI is in a corrective measure mode and is in a process of increasing its base rates so that the liquidity condition is brought under control, but due to this reduction of money supply, the rate of interests offered by the country to foreign investors has increased. Thus, this has led to increase in the foreign capital inflow.

The situation showed a highly polarized figure when the difference between the Indian bonds and the US treasury bills stood at a return difference of almost 5. 7%. This high inflation might compel RBI to increase the base rate even more, leading to more interest rates. Thus, it goes without saying that India would continue being a hot destination for FII's.

For long term sustainable growth, the idea is to infuse more foreign direct investments which would lead to total factor growth productivity rather than only short term market amelioration.

Controlling Hot Money – A Solution

The revised paper of the DTC has retained the clause directing foreign institutional investors to classify income from investments as capital gains and pay tax on it. Foreign institutional investors cannot classify income from capital market transactions as business income. This move would check hot money flow into Indian markets.

Some of the FIIs are characterizing such income as business income and consequently claiming total exemption from taxation. It is therefore, proposed that the income arising on purchase and sale of securities by an FII shall be deemed to be income chargeable under the head capital gains. This measure has a strong chances of curbing the FII Inflow to some extent.

Food Inflation

RBI has increased the interest rates 5 times already this year. This has been in response to the inflation which was in double digits till July. As has been mentioned increasing the interest rate has been the main weapon in the hands of the central bank against the surging inflation India has been facing for more than a year.

Reserve Bank made a baseline projection of WPI inflation for March 2011 of 6 per cent (Subbarao, 2010). Reducing the interest rate goes a long way in easing the supply side capacity constraints and reducing the manufacturing inflation. This is only half the story though. India has been consistently

struggling with a more volatile component of inflation consisting of primary articles. Primary Articles, which includes Food, Cereals and Grains, do not respond to monetary policy measures like interest rates hike (Nagpal, 2010). Controlling primary inflation, particularly food inflation, requires an altogether different approach.

But before we discuss the approach that India should take against the rising food inflation we will go a little deep into what we think are the causes of this problem.

Issues

After 2005, food prices increased at a much faster rate than non-food prices, except in 2008 when the prices of commodities spiked in India and in the global market (Exhibit 10).

Analysis of the above graph reveals some interesting facts:-

Food inflation has been continuously increasing and the inflation in wholesale prices was close to 20% in January 2010.

Annual average food inflation during the period 2006 to 2009 was more than 80% higher than inflation in non-food commodities.

Another important set of data is the commodity wise study of inflation (Exhibit 11). Study of this data suggests that within the food group, the highest inflation is observed in the case of pulses. This is highly significant as pulses are the most important source of proteins for majority of Indians and in particular the people living around the poverty line.

A good example for the study of the problem of food inflation is the year 2008-09.

The year saw an increase in food output of 1. 6%. It still fell short of the demand. More than half of food production reported in a financial year is consumed in the next year. Hence the impact of the low growth in food production during 2008-09 was felt during 2009. In addition to a bad south-west monsoon ultimately led to a drought.

This example clearly indicates that the problem of food inflation is strongly structural in nature. A further analysis of the problem suggests presence of structural gaps in India's policy of food security.

Weaknesses in Food Management Strategy and Policies

Absence of institutional mechanism for an early warning system

The absence of such a system which can track and predict the likely scenario of domestic and global supply and prices, at times lead to delay in exercising the import option.

Current policy lapses

There are numerous such examples like how when the first indications of a serious fall under sugarcane acreage was available in the first week of July 2008 the export of sugar still continued. Between April and September 2008, India exported sugar worth \$960 million and in the following six months (October 2008 to March 2009) it imported sugar worth \$127 million. The situation turned precarious during 2009 and India imported sugar worth \$306 million during the first half of 2009-10 (Chand, 2010).

Continued dependence on Monsoon

ASSOCHAM predicts that in the scenario of Monsoon deficiency of 22% the agricultural output will be (-)6% (See Exhibit) . This is a testimony to the fact that Indian Agricultural is still highly dependent on a good monsoon. Any aberration from a good monsoon and India is highly likely to see a situation of a drought.

Public Distribution System Inefficiencies

Maintaining an adequate inventory is a big problem looming over the country. Except for a buffer stock of rice and wheat by public agencies and sugar stock by various agencies, there is no arrangement in the country to carry large inventories of other food items. Because of this, the stock to consumption ratio for most of the commodities in the country remains low. India needs to invest heavily in expanding storage capacity for various types of foods.

A startling fact which highlights the glaring gaps in the Indian PDS is that 58% of the food grains never reach the poor. This shows that inflation which hits poor more than the rich is also in parts due to poor distribution mechanism of the government.

Suggestions

The solution to the problem of structural inflation which affects the prices of the primary articles lie in heavy spending on infrastructure development. In particular we would like to propose heavy investment on the irrigation infrastructure.

The effect of the improved PDS on the inflation could be understood using the following equation:

Improvement in Irrigation Infrastructure

India is still primarily dependent on irrigation via canals. This irrigation medium uses thrice the required water and is highly wasteful. In addition there are huge roadblocks in building canals due to which a huge area of arable land of India still does not have a irrigation source. This directly implies a dependence on the Monsoon.

We propose that the government should look beyond the traditional ways and try to deploy mechanisms like “ Drip Irrigation” which is not only more reliable and easier to build but reduces wastage multi-folds (Wikipedia, 2010).

Improvement in PDS

The PDS is conceived as a channel through which the Government will ensure availability of food grains at affordable prices and maintain food security. Several opportunities exist to manipulate the system exist with widespread collusion across the supply chain. For every Rs 4 spent on PDS on Rs 1 reaches the poor and 57% of the PDS food grain does not reach the intended people.