

Economic Outlook, Prospects, and Policy Challenges

This year's Economic Survey comes at a time of unusual volatility in the international economic environment. Markets have begun to swing on fears that the global recovery may be faltering, while risks of extreme events are rising. Amidst this gloomy landscape, India stands out as a haven of stability and an outpost of opportunity. Its macro-economy is stable, founded on the government's commitment to fiscal consolidation and low inflation. Its economic growth is amongst the highest in the world, helped by a reorientation of government spending toward needed public infrastructure. These achievements are remarkable not least because they have been accomplished in the face of global headwinds and a second successive season of poor rainfall.

The task now is to sustain them in an even more difficult global environment. This will require careful economic management. As regards monetary and liquidity policy, the benign outlook for inflation, widening output gaps, the uncertainty about the growth outlook and the over-indebtedness of the corporate sector all imply that there is room for easing. Fiscal consolidation continues to be vital, and will need to maintain credibility and reduce debt, in an uncertain global environment, while sustaining growth. On the government's "reform-to-transform" agenda, a series of measures, each incremental but collectively meaningful have been enacted. There have also been some disappointments—especially the Goods and Services Tax—which need to be retrieved going forward. Accelerated structural reforms at the Centre, the dynamism of competitive federalism, and good economics being good politics could all combine to maintain the fundamental promise that is India. For now, but not indefinitely, the sweet spot created by a strong political mandate but, recalibrated to take account of a weaker external environment, is still beckoning there.

INTRODUCTION

1.1 A year ago, the Economic Survey spoke about the “sweet spot” for the Indian economy, arising from a combination of a strong political mandate and a favourable external environment. At the same time, it cautioned against unrealistic expectations of

“Big Bang” reforms because of the dispersed nature of power in India and the absence of that impelling driver—crisis. It argued therefore in favour of a “persistent, creative and encompassing incrementalism” as the guide for prospective action and the benchmark for retrospective assessment.

1.2 This year's Survey comes against the background of an unusually volatile external environment with significant risks of weaker global activity and non-trivial risks of extreme events. Fortifying the Indian economy against possible spillovers is consequently one obvious necessity. Another necessity is a recalibration of expectations.

1.3 If the world economy lurches into crisis or slides into further weakness, India's growth will be seriously affected, for the correlation between global and Indian growth has been growing dramatically (Figure 1). Assessments of India's performance over the coming year will therefore need to be conditional. This is not an advance apology for likely future performance but the sobering reality of India becoming "so entwined" with the world.

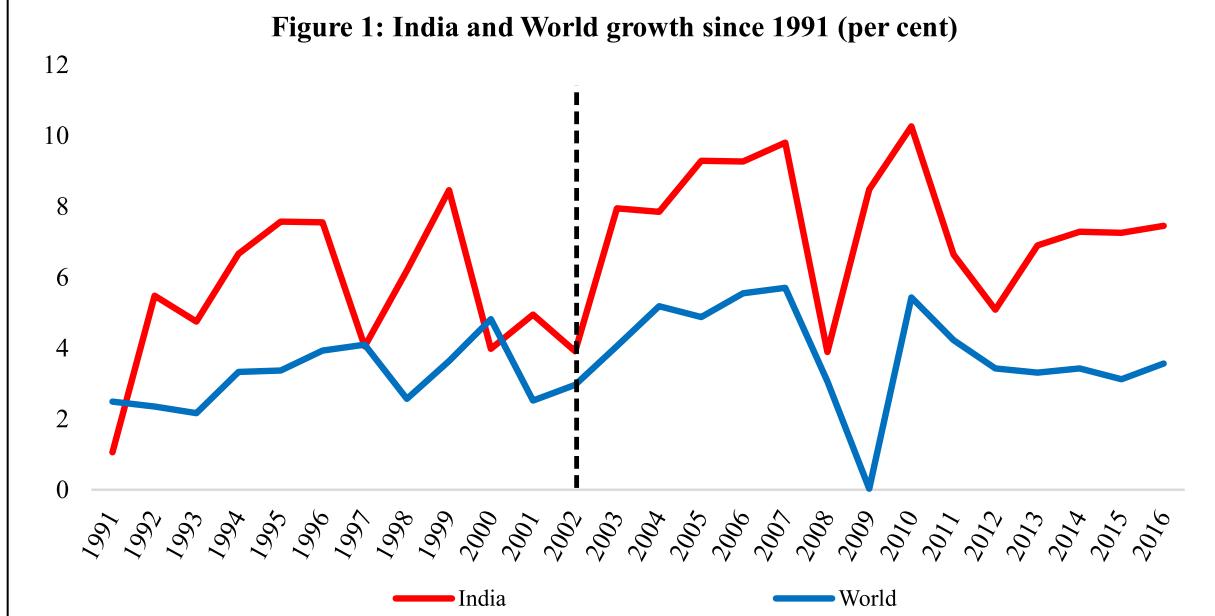
1.4 Looking backward, the obvious question is: how has the economy performed against the standards set in last year's Survey? India's economic performance can be measured against two distinct benchmarks: India versus other countries; and India versus its own medium-term potential. On the first, the Indian economy has fared well; on the second, steady progress is being made and there is still scope for translating potential into actuality.

1.5 Start with the comparisons with other countries. At a time when the newest normal for the world economy is one of turbulence and volatility, India is a refuge of stability and an outpost of opportunity. Its macro-economy is robust, and it is likely to be the fastest growing major economy in the world in 2016. For an economy where exports have declined due to weak global demand and private investment remains weak, India's economy is performing remarkably well.

1.6 In part, this performance reflects the implementation of a number of meaningful reforms, each incremental, but collectively meaningful:

- Creating the palpable and pervasive sense that corruption at the centre has been meaningfully addressed, reflected in transparent auctions of public assets and non-interference in regulatory decisions;
- Liberalizing foreign direct investment (FDI) across-the-board, including by passing the long-awaited insurance bill. FDI reforms reflect a decisive change in philosophy, from viewing FDI as a tolerable necessity to something to welcome;

Figure 1: India and World growth since 1991 (per cent)



Source: World Economic Outlook (WEO), January, 2016 update.

- Vigorously pursuing efforts to ease the cost of doing business, which has allowed India to advance in cross-country competitiveness rankings and become the crucible for “million mutinies” reflected in the unprecedented dynamism of the start-up and e-commerce sectors, and in the interest of large employment-generating companies (Box 1.4 in the Outlook section);
- Restoring stability and predictability in tax decisions, reflected in the settlement of the Minimum Alternate Tax (MAT) imposed on foreign companies, and increasing substantially the limits beyond which the tax department will file appeals;
- Implementing a major public investment program to strengthen the country’s infrastructure and make up for the deficiency of private investment;
- Instituting a major crop insurance program to cushion farmers against adversity;
- Limiting farm interventions which had a first-order effect in moderating overall inflation;
- Elevating to mission mode the financial inclusion agenda via the Jan Dhan Yojana by creating bank accounts for over 200 million people within months. Financial inclusion will also be furthered by the licensing of 11 payments banks and 10 small banks;
- Advancing the game-changing JAM (*Jan Dhan Aadhaar Mobile*) agenda. LPG witnessed the world’s largest direct benefit transfer program, with about 151 million beneficiaries receiving a total of ₹29,000 crore in their bank accounts. The infrastructure is being created for extending the JAM agenda to other government programs and subsidies;
- Attempting to change social norms in a number of areas: open defecation, and voluntarism in giving up subsidies.
- Undertaking comprehensive reforms of

the power sector (especially the UDAY Scheme); and

- Avoiding policy reversals.

1.7 Yet, there was the perception that quantity cannot exculpate quality, that launching and better implementing schemes were privileged over policy changes, and that policies to unlock India’s full supply potential could have been more vigorously advanced. This perception owes in part to a failure to aggregate all the individual reforms and hence to appreciate the sum as more than the parts. It also owes, though, to some disappointments.

1.8 Approval for the game-changing GST bills has proved elusive so far; the disinvestment program fell short of targets, including that of achieving strategic sales; and the next stage of subsidy rationalization is a work-in-progress. Critically, corporate and bank balance sheets remain stressed, affecting the prospects for reviving private investment, a key engine of long term growth.

1.9 Perhaps the underlying anxiety is that the Indian economy is not realizing its full potential. It is incontrovertible that India is still oozing potential. *The country’s long run potential growth rate is still around 8-10 per cent* (Box 1.1 elaborates on this in greater detail). Realizing this potential requires a push on at least three fronts.

1.10 First, India has moved away from being reflexively anti-markets and uncritically pro-state to being pro-entrepreneurship and skeptical about the state. But being pro-industry must evolve into being genuinely pro-competition, and the legacy of the pervasive exemptions Raj and corporate subsidies highlights why favoring business (and not markets) can actually impede competition. Similarly, skepticism about the state must translate into making it leaner, without delegitimizing its essential roles and indeed by strengthening it in important areas.

1.11 Key to creating a more competitive environment will be to address the exit (the

Chakravyuha) problem which bedevils the Indian economy and endures as an impediment to investment, efficiency, job creation and growth (see Chapter 2). The Indian economy had moved from socialism with restricted entry to “marketism” without exit. The government is undertaking a number of initiatives such as introducing a new bankruptcy law, rehabilitating stalled projects, and considering guidelines for public private partnerships that can help facilitate exit, thereby improving the efficiency of the economy.

1.12 Second, major investments in people—their health and education—will be necessary to exploit India’s demographic dividend. Tomorrow’s worker is today’s child or foetus—born to and raised by today’s mothers. It would consequently seem important to focus on “mother and child,” involving maternal health and early life interventions, which is the subject of Chapter 5. Raising the necessary resources for investments in human capital is discussed in Chapter 7.

1.13 More broadly, the delivery of essential services is a gargantuan challenge. With increased devolution of resources, states will need to expand their capacity and improve the efficiency of service delivery. That will require them to shift their focus from outlays to outcomes, and to learn by monitoring, innovating, and even erring.

1.14 Improving service delivery in the wake of the Fourteenth Finance Commission requires an evolution in the relative roles of the Centre and the states: the Centre should focus on improving policies, strengthening regulatory institutions, and facilitating cooperative and competitive federalism while the states mobilize around implementing programs and schemes to ensure better service delivery.

1.15 Third, while dynamic sectors such as services and manufacturing tend to grab public attention, India cannot afford to neglect its agriculture (Chapter 4). After all, nearly 42

per cent of Indian households derive the bulk of their income from farming. Smaller farmers and landless laborers especially are highly vulnerable to productivity, weather, and market shocks changes that affect their incomes. The newly introduced crop insurance schemes should begin to address these problems to a great extent.

1.16 Climate change and emerging scarcities will necessitate a focus on “more for less”, and hence redressing the current system of incentives and subsidies, which encourages using more inputs such as fertilizer, water, and power, to the detriment of soil quality, health and the environment. They also disproportionately benefit rich and large farmers.

1.17 Despite the many challenges, there remains considerable room for optimism. Optimism is engendered by the dynamic of competitive federalism. States that perform well are increasingly becoming “models and magnets.” Successful experiments in one state are models for others states to emulate by showing what can be done and stripping away excuses for inaction and under-performance. They are also magnets because they attract resources, talent and technology away from the lagging states, forcing change via the channel of “exit.”

1.18 Optimism is reinforced by events of the last decade that have re-affirmed the dictum that good economics is good politics, even as frequent elections complicate the task of policy-making. Not always and not everywhere but increasingly, Central and State governments that have delivered rapid growth and better governance tend to get re-elected and vice versa. It is telling, for example, that the state governments that have been elected three times have been the ones that have delivered rapid agricultural growth.

1.19 Furthermore, optimism is also fueled

by the Indian decision-making process which allows—hopefully even creates the pressures—for disappointments to be retrieved. The GST is within reach; new bankruptcy procedures, as well as the revival of some big stalled projects such as Dabhol, illustrate that the exit problem can be solved; not only is the infrastructure being created for the game-changing JAM agenda to be translated into reality, there are

numerous silent revolutions taking place all around the country—sugar and seeds in Uttar Pradesh, food and kerosene in Andhra Pradesh, Chandigarh and Puducherry—that are helping the spread, and hence realizing the promise, of the JAM agenda (discussed in Chapter 3).

1.20 In sum, for now but not indefinitely, the sweet spot for India is still beckoning there.

Box 1.1: What is India's Potential GDP Growth?

India is oozing potential. That is undeniable. But is it measurable?

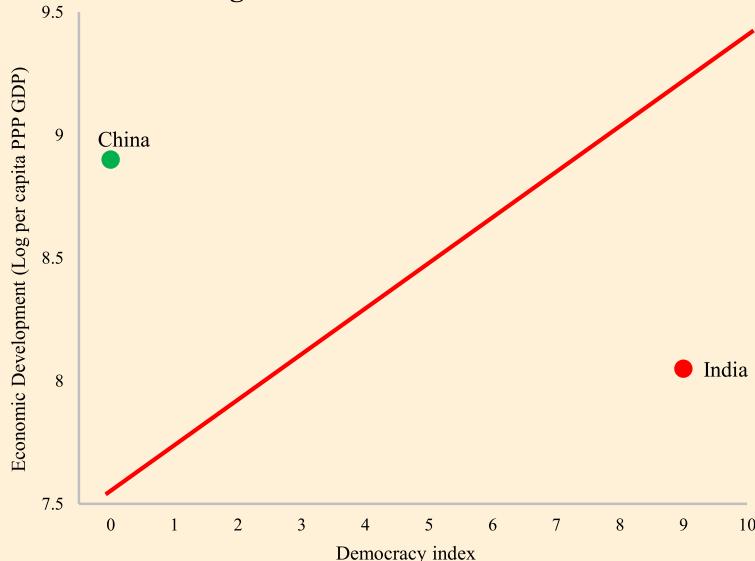
Typically, economists measure a country's potential GDP growth in two ways: first, by extrapolating from past growth; and, second, by projecting the underlying drivers of growth: capital (physical and human), labor, and productivity. Both have limitations and both rely on a variety of assumptions.

The first methodology has many variants, including the use of Hodrick-Prescott filters. But they are all essentially mechanical and are really some weighted average of past growth rates. One disadvantage of this method is that variations in actual growth can induce considerable volatility in estimates of potential growth. But potential growth should be relatively stable unless there are some fundamental shifts in the underlying policy and institutional environment.

Estimating potential GDP by projecting the underlying determinants of growth (as done in Rodrik and Subramanian, “*Why India Can Grow at 7 Per Cent a Year or More*”, Economic and Political Weekly (EPW) [2005]) requires assumptions to be made on total factor productivity growth, which can be arbitrary unless they too are based on past performance which leads to the problems noted above.

A different way of estimating potential GDP growth is to use a deep determinants-cum-convergence framework. There is a well-established literature (North, D, “*Institutions*”, Journal of Economic Perspectives, [1991], Acemoglu, D and J.A. Robinson, “*Why Nations Fail: The Origins of Power, Prosperity and Poverty*”, Crown Business [2012]) that suggests that institutions are a key determinant of long run growth. This is summarized in Figure 1 below.

Figure 1: Institutions Matter

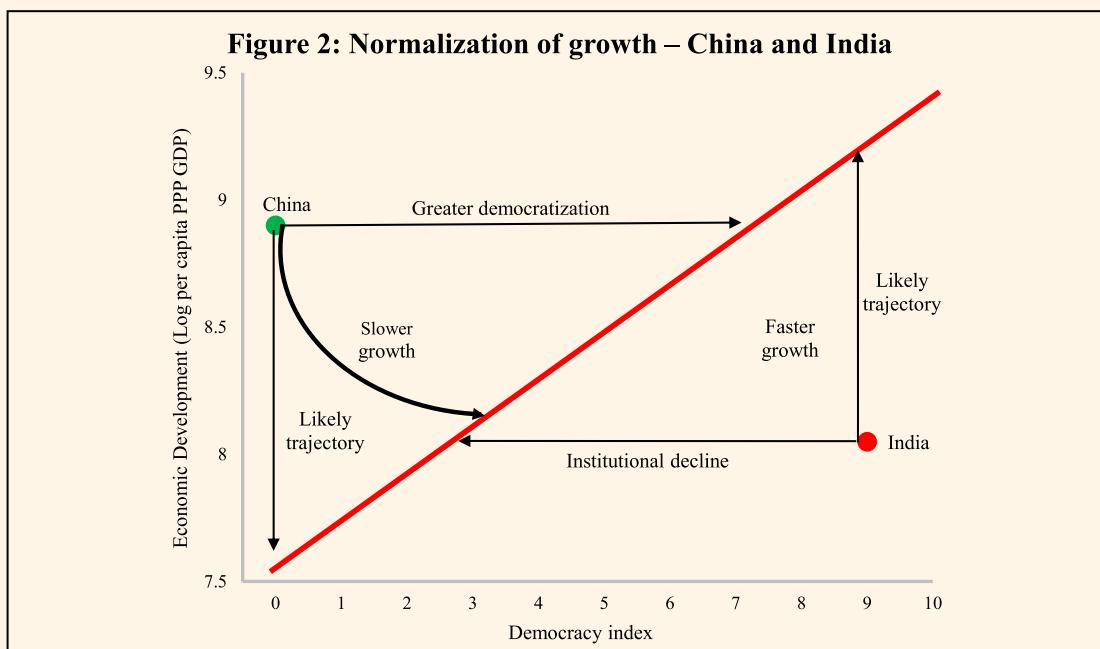


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The upward-sloping line in the figure reflects a strong relationship (on average) between political institutions and economic development that has been found in empirical research, validating the central argument of the “institutions matter” hypothesis. However, China and India are outliers (they are far away from the line of best fit). And the interesting thing is that each of these countries is an exception, or even a challenge, to the relationship but in opposite ways. India (which is way below the line) is not rich enough given its uncontestedly vibrant political institutions. China (which is well above the line) is too rich given its weak democratic institutions.

The assumption is that India and China will mean-revert, that is they will become more typical, and move towards the line of best fit, over the medium term. Mean reversion can happen in different ways. For China, the assumption is that this process of becoming a “normal” country will happen via a combination of slower growth and faster democratization as shown in Figure 2. Indeed, the growth slowdown in China should be seen as a process of normalization after a period of abnormally high growth. For India, normalization should take the form of an acceleration of growth shown in the figure below.

India’s potential growth rate can thus be estimated as a reversion to a state of things where its economic development is consistent with its well-developed political institutions. The question is what is the implied growth rate that is consistent with this mean reversion.



The basic convergence framework provides a framework for estimating, albeit roughly, India’s potential growth rate during this process of normalization (see Technical Appendix for the simple algebra of this computation).

According to convergence theory, India’s per capita GDP growth rate (in PPP terms) between 2015 and 2030 should be some multiple of the difference in the initial level of per capita GDP between the US and India in 2015. That difference is about 2.2 log points. The multiple is called the convergence coefficient—the rate at which India will catch up with the United States. A reasonable parameter from the literature is that this should be about 2 percent per year, at least for countries that are converging. The East Asians converged at a much faster pace but others at a slower pace.

The significance of the figure shown above is that since India has under-achieved so far, it must converge at a faster pace than usual, so that it can revert to the “normal” line. Hence, its convergence coefficient should be substantially better than 2 percent. These PPP-based growth rates need to be converted into market exchange rate growth rates. The resulting estimates are shown in the table below for alternative assumptions about this convergence coefficient.

Based on this analysis, India's medium term growth potential is somewhere between 8 and 10 percent. Of course, this is an estimate of potential, conveying a sense of opportunity. Hard policy choices and a cooperative external environment will be required to convert opportunity into reality.

Table: China and India's Potential Growth Rate, 2015-30 (per cent)

Convergence speed (per cent)	China	India
2	3.3	6.2
2.5	4.1	7.6
3	5.0	9.0
3.5	5.9	10.4

Source: Ministry of Finance calculations

THE GLOBAL CONTEXT

1.21 Since the Economic Survey and Budget were presented a year ago, the Indian economy has continued to consolidate the gains achieved in restoring macroeconomic stability. Inflation, the fiscal deficit, and the current account deficit have all declined, rendering India a relative haven of macro-stability in these turbulent times. Economic growth appears to be recovering, albeit at varying speeds across sectors.

1.22 At the same time, the upcoming Budget and 2016-17 (FY2017) economic policy more broadly, will have to contend with an unusually challenging and weak external environment. Although the major international institutions are yet again predicting that global growth will increase from its current subdued level, they assess that risks remain tilted to the downside. This uncertain and fragile outlook will complicate the task of economic management for India.

1.23 The risks merit serious attention not least because major financial crises seem to be occurring more frequently. The Latin American debt crisis of 1982, the Asian Financial crisis of the late 1990s, and the Eastern European crisis of 2008 suggested that crises might be occurring once a decade. But then the rapid succession of crises, starting with Global Financial Crisis of 2008

and proceeding to the prolonged European crisis, the mini-crises of 2013, and the China-provoked turbulence in 2015 all hinted that the intervals between events are becoming shorter.

1.24 This hypothesis could be validated in the immediate future, since identifiable vulnerabilities exist in at least three large emerging economies—China, Brazil, Saudi Arabia—at a time when underlying growth and productivity developments in the advanced economies are soft (see Box 1.2). More flexible exchange rates, however, could moderate full-blown eruptions into less disruptive but more prolonged volatility.

1.25 One tail risk scenario that India must plan for is a major currency re-adjustment in Asia in the wake of a similar adjustment in China, as such an event would spread deflation around the world. Another tail risk scenario could unfold as a consequence of policy actions—say, capital controls taken to respond to curb outflows from large emerging market countries, which would further moderate the growth impulses emanating from them.

1.26 In either case, foreign demand is likely to be weak, forcing India—in the short run—to find and activate domestic sources of demand to prevent the growth momentum from weakening. At the very least, a tail risk

event would require Indian monetary and fiscal policy not to add to the deflationary impulses from abroad. The consolation

would be that weaker oil and commodity prices would help keep inflation and the twin deficits in check.

Box 1.2: Analytical Taxonomy of Financial Crises, Past and Future

Since the 1980s, external financial crises have followed one of three basic forms: the Latin American, the Asian Financial Crisis (AFC), or the Global Financial Crisis (GFC) model. So one could ask: in the unlikely event that a major event did take place in a systematically important emerging market, which form would it follow? The answer is probably none of the above. The implications would be unlike anything seen in the last 80 years. (The attached table contains a summary).

In the Latin American debt crisis, governments went on a spending binge financed by foreign borrowing (of recycled petrodollars) while pegging their exchange rates. The spending led to a classic sequence: economic overheating, large current account deficits that eventually proved difficult to finance, and finally defaults on the foreign borrowing. The Indian external crisis of 1991 belonged to this category, although the country did not and has never defaulted.

In the AFC of the late 1990s, the transmission mechanism was similar—namely, overheating and unsustainable external positions under fixed exchange rates—but the instigating impulse was private borrowing rather than government borrowing. The troubles in Eastern Europe in 2008 belonged to this category. The 2013 mini-crises in a number of emerging markets following the Federal Reserve’s “taper tantrum” were also similar to the Asian crisis, with the difference that affected countries had more flexible exchange rates which obviated the large disruptive changes that occur when fixed regimes collapse.

The GFC of 2008, with America as its epicentre, was unique in that it involved a systematically important country and originated in doubts about its financial system. The effects radiated out globally, with the irony that even though the problems originated in the American financial system, there was a flight of capital *toward* the United States, which triggered a sharp appreciation of the dollar and significant currency depreciations in emerging markets. In this way, the GFC, while inflicting an adverse financial shock on the rest of the world, simultaneously set in motion an adjustment mechanism that helped emerging markets recover from the crisis.

The Japanese crisis was similar to the GFC in terms of the transmission mechanism (asset price bubbles encompassing equity markets and real estate). But it was dissimilar in that it was corporate rather than household borrowing that was the instigating impulse. Also, the crisis did not have a systemic financial impact, since Japan was not a major international banking centre. Nor did it have a major impact on global exports, even though Japan was (and is) a major global trader, because, as in the GFC, the epicentre’s currency appreciated as the crisis played itself out.

China’s current situation is similar to the AFC case in that fears about excessive corporate debts—in the context of slowing growth and changing economic management—are fostering large capital outflows. But the outcome is less certain, since whereas Asian countries had limited foreign exchange reserves China has more than \$3 trillion in official assets, consequent upon years of running large current account surpluses. This situation gives China much more space and time to deal with incipient problems, and minimize their consequences, for example, by allowing a gradual rather than disruptive decline in the exchange rate.

Were a major event in China or another large emerging market to take place nonetheless, it would be very different from the three categories described above. It would likely involve a large currency depreciation in a systematically important country which would spread outward as a deflationary/competitiveness shock to the rest of the world, especially countries competing with it. Consequently, the built-in adjustment mechanism that took place in the GFC—where the crisis country’s currency appreciated would be absent.

In this sense, a potential tail event in a systematically important emerging market would resemble more the events of the early 1930s when the UK and then the US went off the gold standard, triggering a series of devaluations by other countries, leading to a collapse of global economic activity.

Table: Anatomical Taxonomy of External Financial Crises						
Crisis Type	Originating Countries	Origin of problem	Manifestation	Trigger	Exchange Rate Regime	Remarks
Latin American	Emerging markets (Latin America 1982; India 1991); Small advanced country (Greece 2010 onwards)	Government borrowing	Current account deficit	Speculative attack and exchange rate collapse	Fixed rate	Greece was part of euro, so trigger was sharp rise in interest rates.
Asian Financial Crisis	Emerging markets (East Asia 1997-9; Eastern Europe 2008; Fragile Five 2013); Small advanced country (Spain 2010)	Corporate borrowing	Asset price bubbles; High corporate leverage	“Sudden stop” of capital flows and exchange rate collapse	Fixed rate	Fragile Five had flexible exchange rates. Spain was part of euro.
Japan	Systemically Important	Corporate borrowing	Asset price bubbles; High corporate leverage	Asset price collapse	Floating exchange rate	Yen appreciated after crisis.
Global Financial Crisis	Systemically Important (US 2008)	Bank and consumer borrowing	Asset price bubble in housing	Correction in asset prices	Flexible exchange rate	US dollar appreciated.
The NEXT	Systemically Important	Corporate borrowing	Rising debt, asset price bubbles	“Sudden stop” with potential for sharp exchange rate decline	Managed float	Crisis country’s currency could depreciate substantially.

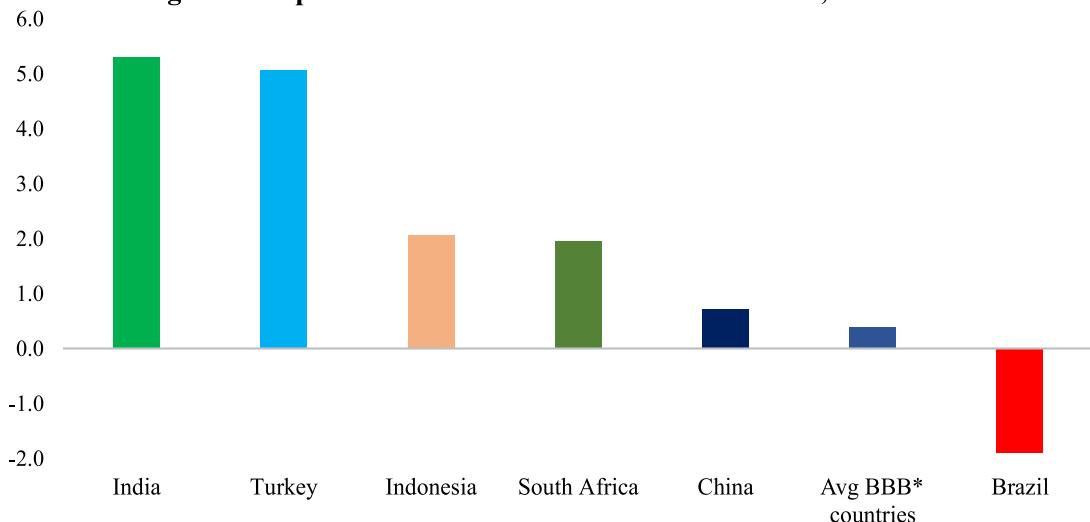
THE INDIAN CONTEXT

1.27 The Indian economy has continued to consolidate the gains achieved in restoring macroeconomic stability. A sense of this turnaround is illustrated by a cross-country comparison. In last year’s Survey, we had constructed an overall index of macroeconomic vulnerability, which adds a country’s fiscal deficit, current account deficit, and inflation. This index showed that in 2012 India was the most vulnerable of the major emerging market countries. Subsequently, India has made the most dramatic strides in reducing its macro-vulnerability. Since 2013, its index has improved by 5.3 percentage points compared with 0.7 percentage point for China, 0.4 percentage point for all countries

in India’s investment grade (BBB), and a deterioration of 1.9 percentage points in the case of Brazil (Figure 2).

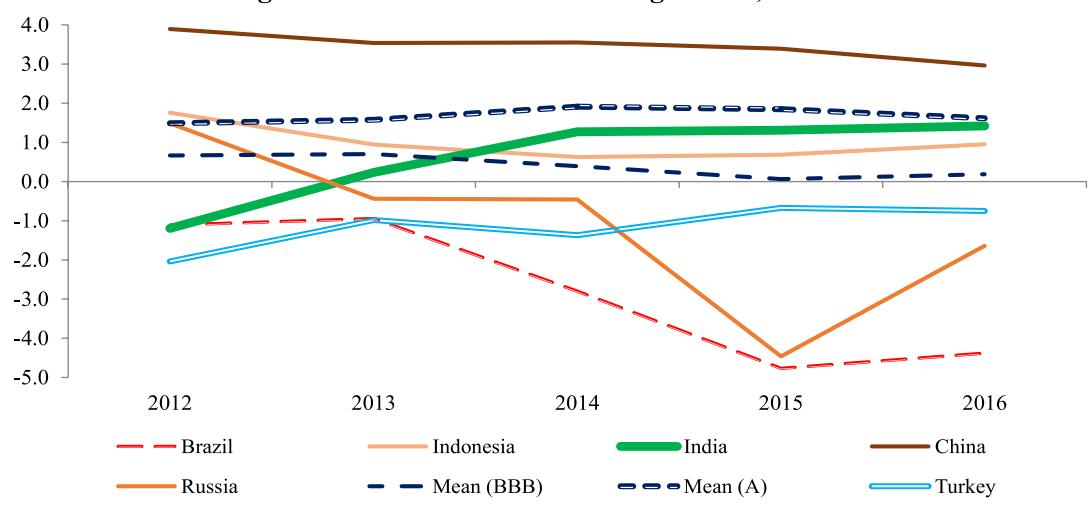
1.28 If macro-economic stability is one key element of assessing a country’s attractiveness to investors, its growth rate is another. In last year’s Survey we had constructed a simple Rational Investor Ratings Index (RIRI) which combined two elements, growth serving as a gauge for rewards and the macro-economic vulnerability index proxying for risks. The RIRI is depicted in Figure 3; higher levels indicate better performance. As can be seen, India performs well not only in terms of the change of the index but also in terms of the level, which compares favourably to its peers in the BBB investment grade and even its “bettters” in the A grade¹. As an investment

¹ India is in the BBB investment category according to Fitch rating agency; A is the category just above it.

Figure 2. Improvement in Macro-Economic Resilience, 2013-2016

Source: IMF WEO, October 2015 and January 2016 update.

* BBB is the classification of countries as per Fitch ratings agency in which India falls.

Figure 3. Rational Investor Ratings Index, 2012-16

Source: IMF WEO, October 2015 and January 2016 update.

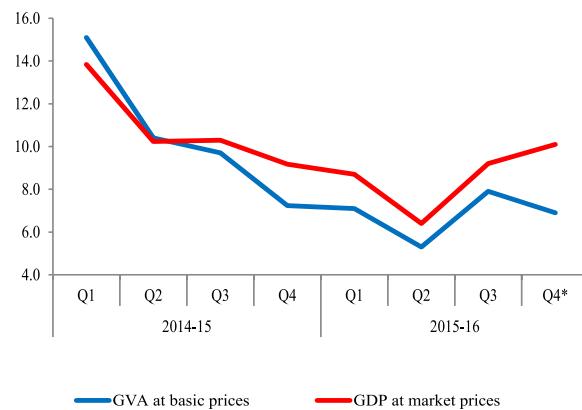
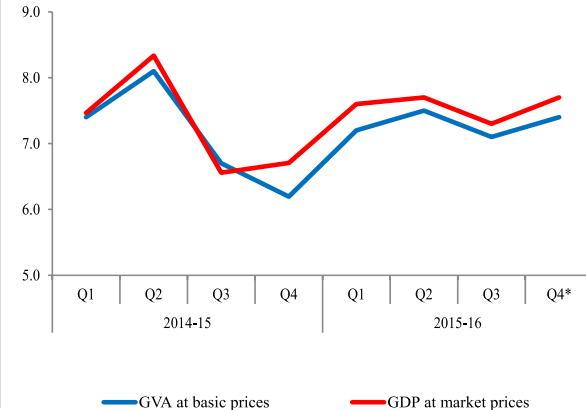
proposition, India stands out internationally.

Review of Major Developments

1.29 In the Advance Estimates of GDP that the Central Statistics Office (CSO) released recently, the growth rate of GDP at constant market prices is projected to increase to 7.6 per cent in 2015-16 from 7.2 per cent in 2014-15, mainly because private final consumption expenditure has accelerated. Similarly, the growth rate of GVA for 2015-16 is estimated at 7.3 per cent vis-à-vis 7.1 per cent in 2014-15

(Figures 4(a) and (b)). Although agriculture is likely to register low growth for the second year in a row on account of weak monsoons, it has performed better than last year. Industry has shown significant improvement primarily on account of the surprising acceleration in manufacturing (9.5 per cent vis-à-vis 5.5 per cent in 2014-15). Meanwhile, services continue to expand rapidly.

1.30 Even as real growth has been accelerating, nominal growth has been

Figure 4a: GVA and GDP Growth (Current Prices)**Figure 4b: GVA and GDP Growth (Constant Prices)**

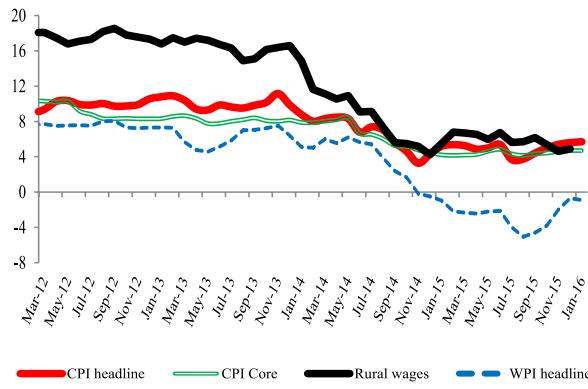
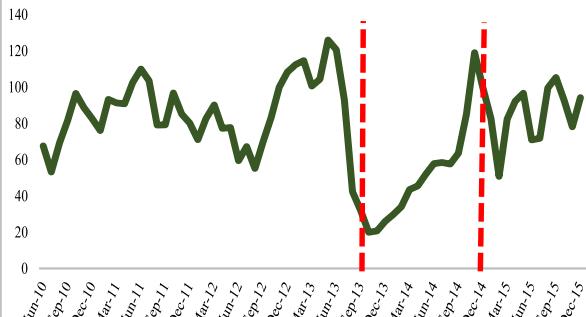
Source: CSO

*GVA growth of Q4 is the implied GVA number from Advanced estimates of 2015-16 and Quarterly estimates by CSO

falling, to historically low levels, an unusual trend highlighted in the Mid-Year Economic Analysis (MYEA), 2015-16. According to the Advance Estimates, nominal GDP (GVA) is likely to increase by just 8.6 (6.8) percent in 2015-16. In nominal terms, construction is expected to stagnate, while even the dynamic sectors (see Box 1.4 for one such example) of trade and finance are projected to grow by only 7 to 7^{3/4} percent.

1.31 Inflation remains under control (Figure 5). The CPI-New Series inflation has

fluctuated around 5^{1/2} percent, while measures of underlying trends—core inflation, rural wage growth and minimum support price increases—have similarly remained muted. Meanwhile, the WPI has been in negative territory since November 2014, the result of the large falls in international commodity prices, especially oil. As low inflation has taken hold and confidence in price stability has improved, gold imports have largely stabilized, notwithstanding the end of a period of import controls (dotted red lines in Figure 6).

Figure 5: WPI and CPI Inflation and rural wage growth (Per cent)**Figure 6: Gold imports* in tonnes (3m MA)**

Source: CSO.

Source: Ministry of Finance.

*Vertical lines in figure 5 indicate the period over which quantitative restrictions on gold imports was in effect (August 2013 to November 2014).

1.32 Similarly, the external position appears robust. The current account deficit has declined and is at comfortable levels; foreign exchange reserves have risen to US\$351.5 billion in early February 2016, and are well above standard norms for reserve adequacy; net FDI inflows have grown from US\$21.9 billion in April-December 2014-15 to US\$27.7 billion in the same period of 2015-16; and the nominal value of the rupee, measured against a basket of currencies, has been steady (Figures 7(a) to (d)). India was consequently well-positioned to absorb the volatility from the U.S. Federal Reserve

actions to normalize monetary policy that occurred in December 2015. Although the rupee has declined against the dollar, it has strengthened against the currencies of its other trading partners.

1.33 The fiscal sector registered three striking successes: ongoing fiscal consolidation, improved indirect tax collection efficiency; and an improvement in the quality of spending at all levels of government.

1.34 Despite the decline in nominal GDP growth relative to the Budget assumption (11.5 per cent in Budget 2015-16 vis-à-vis 8.6 per cent in the Advance Estimates), the

Figure 7a: Current Account Deficit (per cent of GDP)

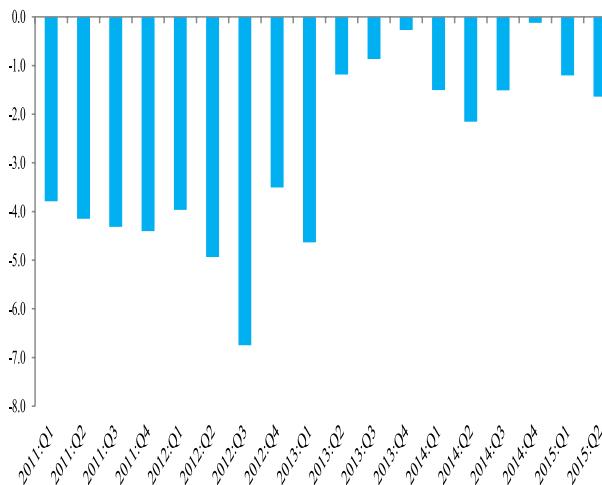


Figure 7b: Foreign Exchange Reserve (US\$ billion)

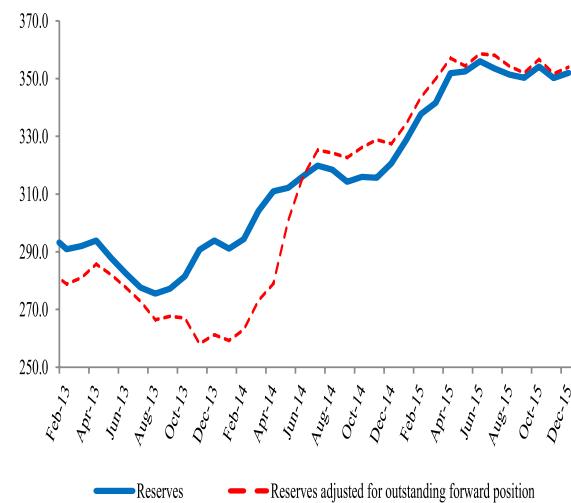


Figure 7c: Trends in major components of Capital Inflows (US\$ billion)

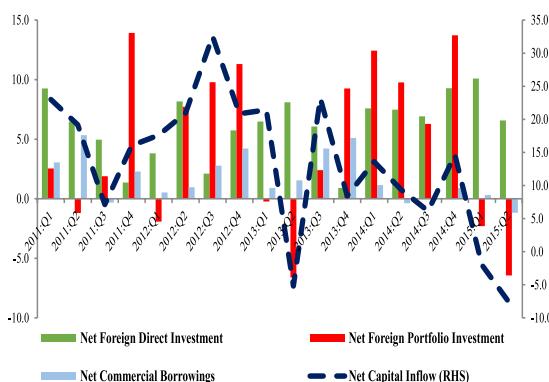


Figure 7d: Index of NEER, REER and US dollar exchange rate (2010=100)



Source: RBI.

central government will meet its fiscal deficit target of 3.9 per cent of GDP, continuing the commitment to fiscal consolidation. Even on the IMF's definition, the fiscal deficit is expected to decline from 4.2 per cent of GDP in 2014-15 to 4.0 per cent of GDP in 2015-16. Moreover, the consolidated revenue deficit has also declined in the first 8 months (for which data are available) by about 0.8 percentage points of GDP.

1.35 Government tax revenues are expected to be higher than budgeted levels. Direct taxes grew by 10.7 per cent in the first 9 months (9M) of 2015-16. Indirect taxes were also buoyant. In part, this reflected excise taxes on diesel and petrol and an increase in the Swachh Bharat cess. The central excise duty collection from petroleum products during April to December 2015-16 recorded a growth of 90.5 per cent and stood at Rs. 1.3 lakh crore as against Rs. 0.7 lakh crore in the same period last year. Tax performance also reflected an improvement in tax administration because revenues increased even after stripping out the additional revenue measures (ARMs). Indirect tax revenues grew by 10.7 per cent (without ARMs) and 34.2 per cent (with ARMs). Table 1 shows that tax buoyancy of direct and indirect taxes improved in 2015-16 vis-à-vis the average of the last three years, although more so for indirect taxes.

1.36 The fiscal stance matters not just for macro-economic outcomes but also for the quality of spending. The budget envisaged an improvement in quality by shifting expenditures away from current to capital expenditures. With the acceptance of the Fourteenth Finance Commission recommendations, and the large devolution toward the states as well as re-structuring of the centrally sponsored schemes, the quality of expenditure must increasingly be assessed from a general government (i.e. combining the center and the states) perspective. This is done in greater detail in Box 1.3.

1.37 The main findings are that a welcome shift in the quality of spending has occurred from revenue to investment, and towards social sectors. Aggregate public investment has increased by about 0.6 per cent of GDP in the first 8 months of this fiscal year, with contributions from both the Centre (54 per cent) and states (46 per cent).

OUTLOOK

Real GDP growth

1.38 Real GDP growth for 2015-16 is expected to be in the 7 to $7^{3/4}$ range, reflecting various and largely offsetting developments on the demand and supply sides of the Indian economy. Before analyzing these factors, however, it is important to step back and note one important point.

Table 1: Tax buoyancy

Year	Base Growth	Revenue Growth		Implied Buoyancy	
		DT	IDT	DT	IDT
2012-13	15.1	18.5	25.8	1.2	1.7
2013-14	11.4	13.5	4.1	1.2	0.4
2014-15	12.7	8.2	8.0	0.6	0.6
Avg. 2012-15	13.1	13.4	12.6	1.0	1.0
9M 2015	8.3	9.2	11.7	1.1	1.4

Note:

1. Base is summation of GVA in manufacturing and services at current market price.
2. Annual numbers are average of four quarters in that year

DT= Direct Tax

IDT= Excise tax plus service tax

9M= April-December

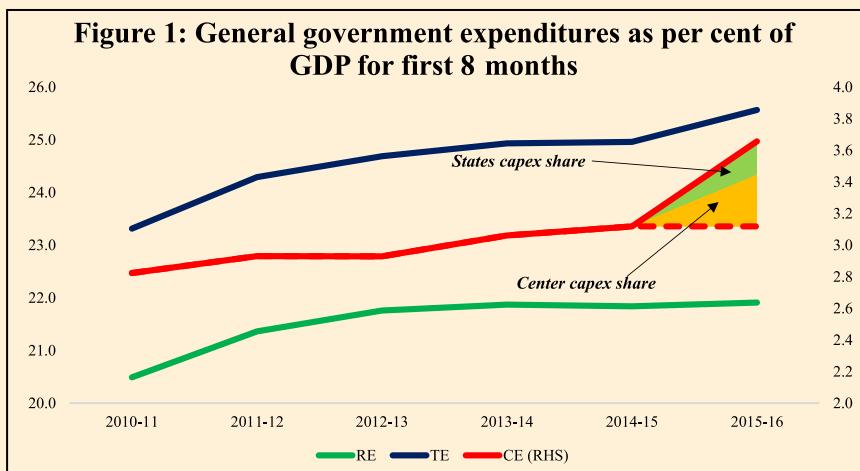
Source: CSO and Controller General of Accounts.

Box 1.3: Assessing the Quality of General Government Spending in FY2016

The 2015-16 Union budget envisaged an improvement in the quality of expenditure, shifting resources from current to capital spending and devoting more resources to the agricultural sector at a time of farm distress. At the same time, the recommendations of the Fourteenth Finance Commission, which were accepted by the government, implied that a much greater portion of revenues would be spent by the states. As a result, understanding whether the shift in Union strategy has been successful requires analysing general government (Centre plus states) expenditures, and not just those of the Centre.

In continuation of the analysis done for the Mid-Year Economic Analysis (MYEA) 2015-16, which covered the first half (H1) of 2015-16, we now report the results of this analysis for the first 8 months of this fiscal year (FY2016). These results are also illustrated in the figures below. Two points are noteworthy.

First, there was a significant increase in aggregate capital expenditure of the general government.¹ Such spending increased by 0.6 percentage points of GDP² (Figure 1). Disaggregating further reveals that the increase in capital expenditures occurred both in the Centre and states, with the former contributing 54 per cent and the latter 46 per cent. Thus, the overall budgetary strategy of accelerating public investment seems to be working at an all-India level.



Second, in the first 8 months of FY2016, general government expenditure witnessed an uptick in the three major social sectors—education, health, and agriculture and rural development—both as a share of GDP and in real terms³ (Figure 2 & 3). For example, real expenditure on education, health, and agriculture and rural development recorded growth of 4.7 per cent, 9 per cent and 8.1 per cent, respectively. Available data does not allow for a further disaggregation of these developments into contributions by the centre and states.

Figure 2: General Government Expenditure in first 8 months (% of GDP)

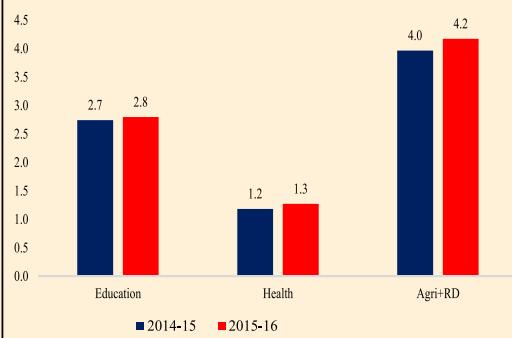


Figure 3: Real expenditure growth in first 8 months 2015-16



Source: Controller General of Account, Comptroller and Auditor General of India, CSO and Calculations.

¹ Capital expenditure for the Centre includes loans and advances whereas capital expenditure for the states does not due to non-availability of data.

² For simplicity, the GDP for the full year has been divided equally across the year.

³ Health expenditure, and Agriculture and Rural Development expenditures have been deflated by the relevant CPI indices.

1.39 India's long-run potential GDP growth is substantial, about 8-10 percent (Box 1.1). But its actual growth in the short run will also depend upon global growth and demand. After all, India's exports of manufactured goods and services now constitute about 18 percent of GDP, up from about 11 percent a decade ago.

1.40 Reflecting India's growing globalization, the correlation between India's growth rate and that of the world has risen sharply to reasonably high levels. For the period 1991-2002 this correlation was 0.2. Since then, the correlation has doubled to 0.42 (Figure 1). In other words, a 1 percentage point decrease in the world growth rate is now associated with a 0.42 percentage point decrease in Indian growth rates.

1.41 Accordingly, if the world economy remains weak, India's growth will face considerable headwinds. For example, if the world continues to grow at close to 3 percent over the next few years rather than returning to the buoyant 4-4½ per cent recorded during 2003-2011, India's medium-term growth trajectory could well remain closer to 7-7½ per cent, notwithstanding the government's reform initiatives, rather than rise to the 8-10 per cent that its long-run potential

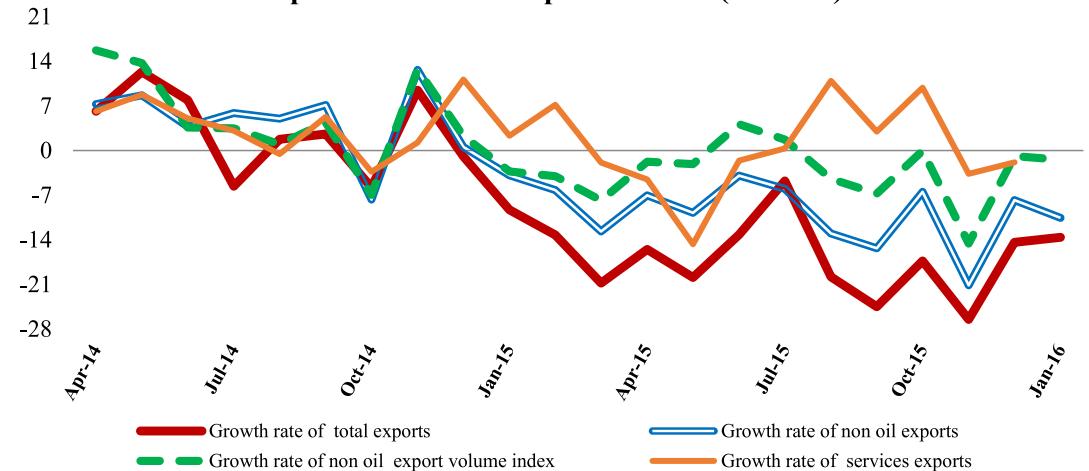
suggests. In other words, in the current global environment, there needs to be a recalibration of growth expectations and consequently of the standards of assessment.

1.42 Turning to the outlook for 2016-17, we need to examine each of the components of aggregate demand: exports, consumption, private investment and government.

1.43 To measure the demand for India's exports, we calculate a proxy-weighted average GDP growth rate of India's export partners. The weights are the shares of partner countries in India's exports of goods and services. We find that this proxy for export demand growth declined from 3.0 percent in 2014 to 2.7 per cent in 2015, which helps explain the deceleration in India's non-oil exports, although the severity of the slowdown—in fact, a decline in export volume—went beyond adverse external developments (Figure 8). Current projections by the IMF indicate that trading partner growth this year will improve marginally this year to about 2.8 percent. But the considerable downside risks suggest that it would be prudent not to count on a big contribution to GDP growth from improving export performance.

1.44 On the domestic side, two factors could boost consumption. If and to the extent

Figure 8: Growth rate of value of total exports, commercial services exports & non-oil exports and non-oil exports volume (Per cent)



Source: RBI.

that the Seventh Pay Commission (7th PC) is implemented, increased spending from higher wages and allowances of government workers will start flowing through the economy. If, in addition, the monsoon returns to normal, agricultural incomes will improve (see Box 1.5), with attendant gains for rural consumption, which over the past two years of weak rains has remained depressed.

1.45 Against this, the disappearance of much of last year's oil windfall would work to reduce consumption growth. Current prospects suggest that oil prices (Indian crude basket) might average US\$ 35 per barrel next fiscal year compared with US\$ 45 per barrel in 2015-16. The resulting income gain would amount roughly equivalent to 1 percentage point of GDP – an 18 per cent price decline times a share of net oil imports in GDP of 6 percent. But this would be half the size of last year's gain, so consumption growth would slow on this account next year.

1.46 According to analysis done by Credit Suisse, (non-financial) corporate sector profitability has remained weak, falling by 1 percent in the year to December 2015.² This decline reflected a sharp deterioration in the financial health of the metals—primarily steel—companies, which have now joined the ranks of companies under severe financial stress. As a result, the proportion of corporate debt owed by stressed companies, defined as those whose earnings are insufficient to cover their interest obligations, has increased to 41 percent in December 2015, compared to 35 percent in December 2014.³ In response to this stress, companies have once again been compelled to curb their capital expenditures substantially.

1.47 Finally, the path for fiscal consolidation will determine the demand for domestic output from government. The magnitude of the drag on demand and output will be largely equal to the size of consolidation, assuming a multiplier of about 1.

1.48 There are three significant downside risks. Turmoil in the global economy could worsen the outlook for exports and tighter financial conditions significantly. Second, if contrary to expectations oil prices rise more than anticipated, this would increase the drag from consumption, both directly, and owing to reduced prospects for monetary easing. Finally, the most serious risk is a combination of the above two factors. This could arise if oil markets are dominated by supply-related factors such as agreements to restrict output by the major producers.

1.49 The one significant upside possibility is a good monsoon. This would increase rural consumption and, to the extent that it dampens price pressures, open up further space for monetary easing (Box 1.6).

1.50 Putting these factors together, we expect real GDP growth to be in the 7 to 7^{3/4} per cent range, with downside risks because of ongoing developments in the world economy. The wider range in the forecast this time reflects the range of possibilities for exogenous developments, from a rebound in agriculture to a full-fledged international crisis; it also reflects uncertainty arising from the divergence between growth in nominal and real aggregates of economic activity.

² As measured by EBITDA, a common measure of cash flow profits; it refers to earnings before interest, taxes, depreciation, and amortization.

³ An interest coverage ratio (ICR) less than 1 implies that the corporation is under financial stress, since its earnings are not sufficient to service its interest obligations. Research indicates that an interest cover of below 2.5x for larger companies and below 4x for smaller companies is considered below investment grade. ICR is typically measured by calculating the ratio of earnings before interest and taxes (EBIT) to interest obligations.

Box 1.4: Startups and Dynamism

One part of the economy that is witnessing unusual dynamism is the start-up sector, focused on e-commerce and financial services. As of January 2016, there were 19,400 technology-enabled startups in India, of which 5,000 had been started in 2015 alone.¹ No less than 2000 of the startups have been backed by venture capital/angel investors since 2010, of which 1005 were created in 2015 alone. Indian start-ups raised \$3.5 billion in funding in the first half of 2015, and the number of active investors in India increased from 220 in 2014 to 490 in 2015.² As of December 2015, eight Indian startups belonged to the ‘Unicorn’ club (valuations greater than \$1 billion).

It is important that start-ups, too, see “exit” (the theme of Chapter 2), which would take the form of these companies being listed, allowing the original private investors to cash in on the initial investment, and plough it back into other similar ventures. Exit valuations in India are still low but are expected to increase as the impact of new SEBI policies on listings comes into effect, and as equity markets in general revive from current low valuations caused by a sense of gloom in the global economy.

¹ Based on the research done by Your Story and iSPiRT.

² NASSCOM report titled “*Startup India-Momentous Rise of the Indian Startup Ecosystem*”.

Box 1.5: El Niño, La Niña and Forecast for FY 2017 Agriculture

From time to time, agricultural production is affected by El Niño, an abnormal warming of the Pacific waters near Ecuador and Peru, which disturbs weather patterns around the world. The 2015 El Niño has been the strongest since 1997, depressing production over the past year. But if it is followed by a strong La Niña, there could be a much better harvest in 2016-17.

The 1997 episode lasted roughly from April 1997 to June 1998. During these 15 months, the Oceanic Nino Index (ONI) – which compares east-central Pacific Ocean surface temperatures to their long-term average and is used by the US National Oceanic and Atmospheric Administration (NOAA) for identifying El Niño events – was consistently positive and greater than 0.5 degrees Celsius.

The current El Niño started around February 2015; most climate models predict a return to “neutral” conditions not before May 2016. That makes it just as long as the 1997-98 event. Also, in terms of intensity, it is comparable to that of 1997-98: The most recent Oceanic Nino Index (ONI) value of 2.3 degree Celsius for November 2015-January 2016 tied with the level for the same period of 1997-98.

An extended and strong El Niño explains why India had a deficient south-monsoon and dry weather lasting through the winter this time. The prolonged moisture stress from it has, in turn, impacted both kharif as well as the rabi crop. The figure below shows that average agricultural growth in El Niño years since between 1981-82 and 2015-16 has been -2.1 per cent compared with a period average of 3.

There is a silver lining here, though. Since 1950, there have been 22 El Niño events of varying durations and intensities, according to NOAA data. But out of the 21 prior to this one, 9 have been followed by La Niña, involving an abnormal cooling of sea surface waters along the tropical west coast of South America with an ONI less than minus 0.5 degrees Celsius. This phenomenon – there have been 14 such events since 1950 – has been associated with normal-to-excess monsoons in India, which may be a by-product of atmospheric convection activity shifting to the north of Australia.

Now, it is important that some of the strongest El Niño years (1997-98, 1972-73, 2009-10, 1986-87 and 1987-88, ranked in the order of strength and of which the last four produced droughts in India) were followed by La Niña episodes, resulting in bumper harvests. The possibility of this being repeated in 2016 after the second strongest El Niño on record cannot be ruled out. The figure below shows, for example, that average growth in La Niña years was 8.4 per cent, substantially higher than the period average.

Figure: Agricultural Growth, 1981-82 to 2015-16 (average, Per cent)



El Niño years (very strong, moderate):

1982-83, 1986-87, 1987-88, 1991-92, 1997-98, 2002-03, 2009-10, 2015-16

La Niña years (strong, moderate):

1988-89, 1998-99, 1999-00, 2007-08, 2010-11

But there is a big catch. El Niño, as of now, continues to be “strong” and is only gradually weakening. It will enter neutral zone only with the onset of summer. NOAA’s latest forecast assigns only a 22 per cent probability of La Niña developing in June-July-August, going up to 50 per cent for September-October-November. The Australian Bureau of Meteorology suggests the “neutral” state as the “most likely for the second half of the year”.

In other words, one shouldn’t expect La Niña conditions to develop before the second half of the southwest monsoon season (June-September). Even if it develops, the translation into actual rainfall in India could take time. The effects of the 2015 El Niño, after all, were felt only from July, although the east-central Pacific sea surface temperature anomalies began in February.

In sum, La Niña is unlikely to deliver its full bounty in the coming monsoon, or at least not until late in the kharif season. That doesn’t, however, mean the monsoon is going to be bad, especially when all models are pointing to a very low probability of a repeat El Niño happening this year. The monsoon could also be good due to other favourable factors such as a “positive Indian Ocean Dipole”. The latter phenomenon – where the western tropical Indian Ocean waters near Africa become warmer relative to those around Indonesia – prevented at least two El Niño years (1997 and 2006) from resulting in droughts in India.

The policy implication of such a cautious prognosis is that the government should be ready with a contingency plan for a monsoon, especially after two successive drought years. *Declaring minimum support prices well before kharif sowing operations, incentivizing farmers to produce crops most prone to domestic supply pressures (such as pulses), and timely contracting of imports of sensitive commodities would be essential components of this strategy.*

Box 1.6: Addressing the Twin Balance Sheet Challenge

One of the most critical short-term challenges confronting the Indian economy is the twin balance sheet (TBS) problem—the impaired financial positions of the Public Sector Banks (PSBs) and some large corporate houses—what we have hitherto characterized as the '*Balance Sheet Syndrome with Indian characteristics*'. By now, it is clear that the TBS problem is the major impediment to private investment, and thereby to a full-fledged economic recovery.

The problems in the banking system have been growing for some time. Stressed assets (nonperforming loans plus restructured assets) have been rising ever since 2010, impinging on capital positions, even as the strictures of Basel III loom ever closer on the horizon. Banks have responded by limiting the flow of credit to the real economy so as to conserve capital, while investors have responded by pushing down bank valuations, especially over the past year. The shares of many banks now trade well below their book value.

This balance sheet vulnerability is in some ways a mirror and derivative of similar frailties in the corporate sector, especially the large business houses that borrowed heavily during the boom years to invest in infrastructure and commodity-related businesses, such as steel. Corporate profits are low while debts are rising, forcing firms to cut investment to preserve cashflow.

This situation is not sustainable; a decisive solution is needed. But finding one is difficult. For a start, given the intertwining set of problems, solutions must strengthen both sets of balance sheets. Some steps have already been taken. In August last year, the government launched the *Indradhanush* scheme, which includes a phased program for bank recapitalization. Meanwhile, the RBI initiated the 5:25 and SDR schemes, which create incentives for the banks to come together with their borrowers to rehabilitate stressed assets. These are good initial steps which might require follow-up.

Resolving the TBS challenge comprehensively would require *4 Rs : Recognition, Recapitalization, Resolution, and Reform*. Banks must value their assets as far as possible close to true value (recognition) as the RBI has been emphasizing; once they do so, their capital position must be safeguarded via infusions of equity (recapitalization) as the banks have been demanding; the underlying stressed assets in the corporate sector must be sold or rehabilitated (resolution) as the government has been desiring; and future incentives for the private sector and corporates must be set right (reform) to avoid a repetition of the problem, as everyone has been clamouring.

But there is a needed sequence to these *4 Rs*: Recognition must come first, but it must be accompanied by an adequate supply of resources; otherwise, banks will be vulnerable. Given the tight fiscal position, where might the resources to recapitalise PSB's come from?

One possible source is the public sector's own balance sheet. For example, the government could sell off assets that it no longer wants to hold, such as certain nonfinancial companies, and use the proceeds to make additional investments in the PSBs. This option is reasonably well understood. What is less appreciated is that RBI could do the same. That is to say it could redeploy its capital as well.

Like all financial firms, central banks hold capital to provide a buffer against the risks they take. In the case of central banks, risks arise because the value of the foreign exchange reserves in terms of domestic currency fluctuates along with the exchange rate, while the value of the government securities they own changes as interest

Figure: Total Equity (capital, retained earnings and contingencies) as Percent of Balance Sheet of Major Central Banks



Source: Bank for International Settlements (BIS).

rates move. Measuring these risks and calculating how much buffer should be provided against them is difficult. For that reason, central bank capital holdings vary widely.

The figure above depicts the ratio of shareholder equity to assets for various central banks. Shareholder equity is defined to include capital plus reserves (built through undistributed retained earnings) plus revaluation and contingency accounts. The chart shows that RBI is an outlier with an equity share of about 32 per cent, second only to Norway and well above that of the U.S. Federal Reserve Bank and the Bank of England, whose ratios are less than 2 per cent. The conservative European Central Bank (ECB) and some EM central banks have much higher ratios, but even they do not approach the level of the RBI.

If the RBI were to move even to the median of the sample (16 per cent), this would free up a substantial amount of capital to be deployed for recapitalizing the PSBs.

Of course, there are wider considerations that need to be taken into account. Most important, any such move would need to be initiated jointly and cooperatively between the government and the RBI. It will also be critical to ensure that any redeployment of capital would preserve the RBI's independence, integrity, and financial soundness—and be seen to do so. At this stage, what is important is the broader point: that funds for recapitalization can be found, at least to a certain extent, by reallocating capital that already exists on the public sector's balance sheet.

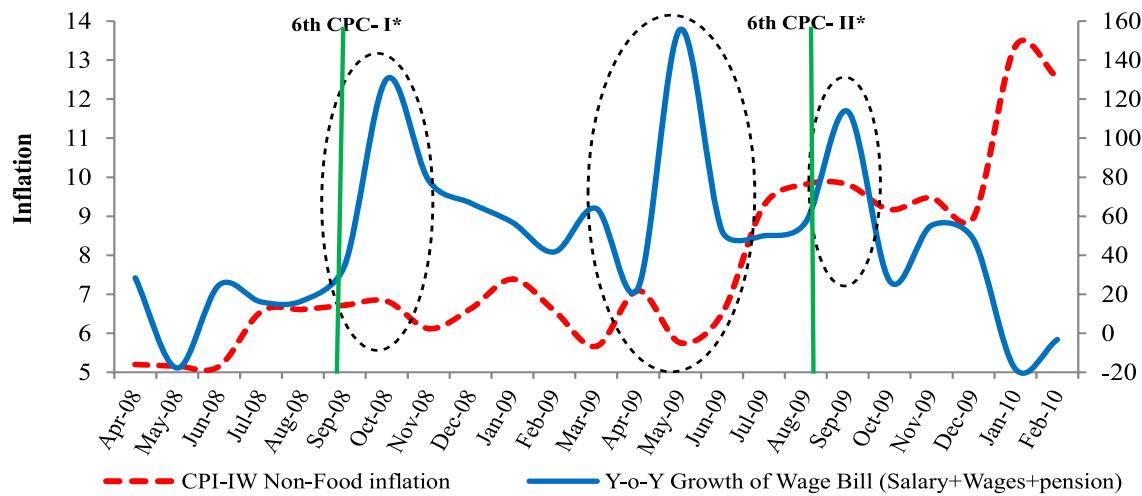
Once the resources to back recognition are identified, the remaining **2 Rs** (Resolution and Reform) can be pursued with vigour. There are many options here, including creating "bad banks" to implement the four **Rs**.

Inflation

1.51 For most of the current fiscal year, inflation has remained quiescent, hovering within the RBI's target range of 4-6 percent. But looming on the horizon is the increase in wages and benefits recommended for government workers by the Seventh Pay Commission (7th PC). If the government accepts this recommendation, would it destabilize prices and inflation expectations? Most likely, it will not.

1.52 The historical evidence is clear on this point. Figure 9 illustrates the experience of the Sixth Pay Commission (6th PC). It plots the monthly increase in salaries during the period of the award, from September 2008 – September 2009, against non-food inflation. (At that time, overall inflation was rising due to a sharp increase in global food prices.) The figure shows that the 6th PC award barely registered on inflation despite the lumpiness of the award, owing to the grant of arrears. If the 6th PC award barely registered, the 7th

Figure 9: Non-Food Inflation and Growth in Wage Bill after 6th PC (Per cent)



Source: CSO, 6th Pay Commission report, Budget documents and CGA.

*Reflecting the phased implementation of the 6th PC, the vertical lines indicate the timing of grant of arrears.

PC is unlikely to either, given the relative magnitudes: even if fully implemented, the expected wage bill (including railways) will go up by around 52 per cent under the 7th PC vis-à-vis 70 per cent under the 6th PC.

1.53 This outcome may seem surprising. *Why would such a large wage increase have so little impact on inflation?* There are three reasons. Most important is a broad theoretical point. In principle, inflation reflects the degree to which aggregate demand exceeds aggregate supply. And pay awards determine only one small part of aggregate demand. In fact, they do not even determine government demand: that depends on the overall fiscal deficit, which is the difference between how much the state is injecting into the economy through overall spending and how much it is taking away through taxes. Since the government remains committed to reducing the fiscal deficit, the pressure on prices will diminish, notwithstanding the wage increase.

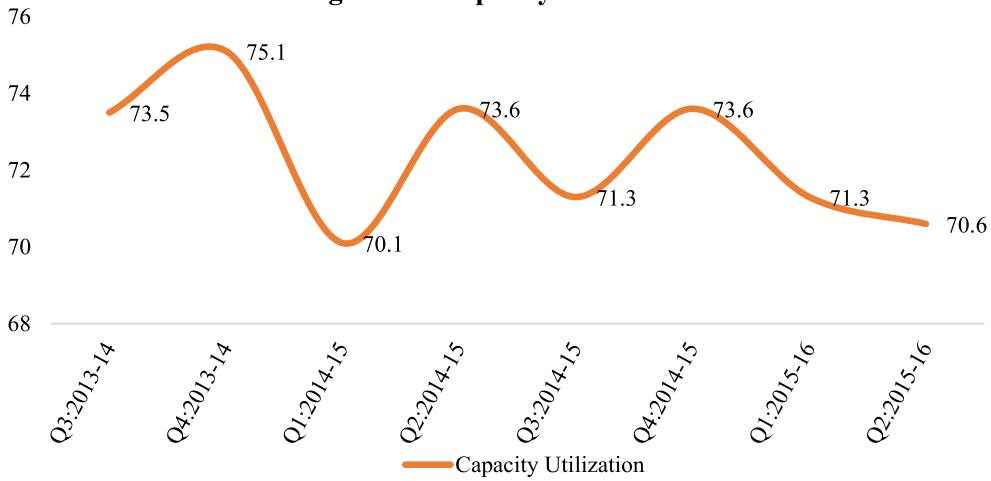
1.54 That said, theory does suggest that a sharp increase in public sector wages could affect inflation if it spilled over into private sector wages and hence private sector demand. But currently this channel

is muted, since there is considerable slack in the private sector labour market, as evident in the softness of rural wages (see Figure 4). And even if private sector wage increases nonetheless do quicken somewhat, the existence of substantial capacity under-utilization (Figure 10) suggests that firms might find it difficult to pass the cost increase onto consumer prices.

1.55 Finally, there will be some mechanical impact of the increase in the house rent allowance (HRA) on the housing component of the CPI. But this effect is likely to be modest between 0.15 and 0.3 percentage points.⁴ And even then it will merely have a one-off effect on the level of the CPI, rather than the rate of inflation going forward, which is the real target of the RBI.

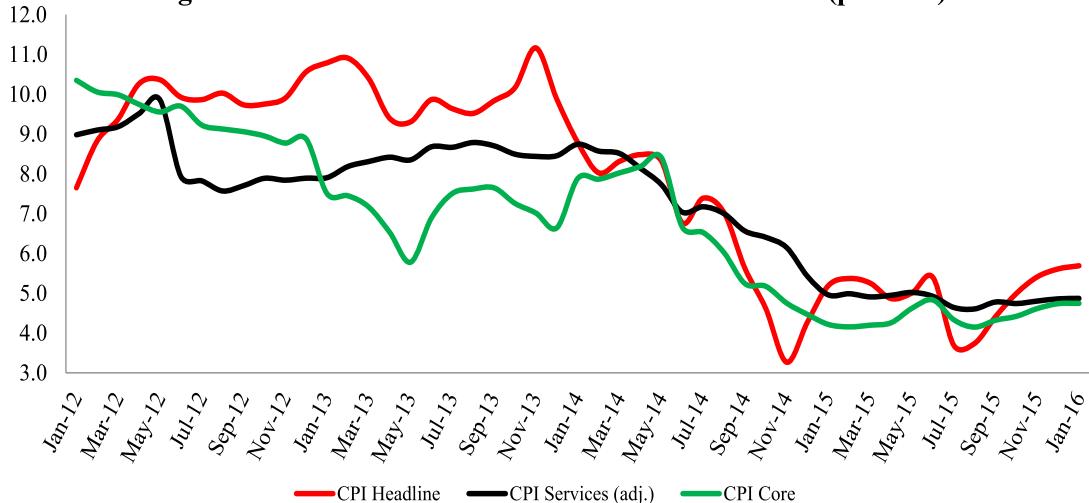
1.56 The outlook for inflation will consequently depend on other factors. On the domestic side, another year of below-potential growth will mean that the output gap (reflected for example in the declining capacity utilization) will widen further. As a result, there will be additional downward pressure on underlying inflation, which has already fallen below 5 percent, as measured

Figure 10: Capacity Utilization



Source: RBI.

⁴ The weight of rented government housing in the overall CPI is 0.35 per cent. But this includes central and state governments and public sector undertakings. Since only central government housing allowances are relevant, the impact on the CPI would be further moderated.

Fig 11: Headline CPI vis-à-vis Core CPI inflation and (per cent)

Source: CSO.

by services inflation excluding the oil-related sub-indices (Figure 11). Meanwhile, if the monsoon returns to normal, food prices will ease, especially since the government remains committed to disciplined increases in MSPs for cereals, and rural wage growth remains muted.

1.57 Further relief should come from abroad. Oil prices have plunged in the first two months of 2016, as have some commodity prices, suggesting that input prices are likely to be lower next fiscal year. Beyond this factor lie other deflationary forces. As growth in China continues to slow, excess capacity there could continue to increase, which will put further downward pressure on the prices of tradable goods all around the world. Part of this might be offset by upward pressure coming from a depreciation of the rupee, especially if the Federal Reserve Bank continues to raise interest rates, prompting capital to reflow to the U.S, although the prospects of aggressive Fed action are receding. On balance the risk to imported pressures, as with domestic pressures, remains firmly to the downside.

1.58 All this suggests that the RBI should be

able to meet its target of 5 percent by March 2017. Indeed, with the current stance, there is a possibility of undershooting. While the current policy rate seems “neutral” in that it is only modestly higher than consumer price inflation, liquidity conditions are unusually tight, impeding the passthrough of recent declines in policy rates to the actual bank rates faced by borrowers (see Box 1.7).⁵

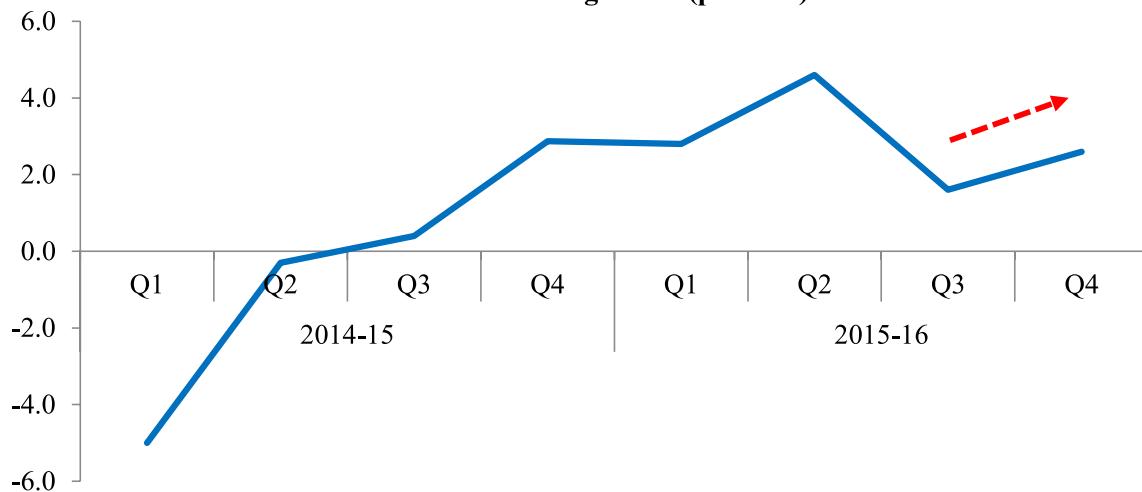
1.59 Figure 12 depicts the situation. It shows a measure of the tightness of monetary conditions: the gap between bank lending (base) rates and nominal GVA growth. If the difference is negative, then nominal GVA growth—and for the average firm, revenue growth—is increasing faster than interest is accruing on its debts. In that sense, the monetary stance poses little problems for the corporate sector. But if interest rates are higher than nominal GDP growth, firms’ cash flows are being squeezed. If firms then respond by curbing price increases in order to boost sale volumes sales and cash flow, this will put downward pressure on inflation. The chart shows that this is indeed what has broadly been happening this year.

⁵ Of course, bank lending rates have also been influenced by weaknesses in firm balance sheets, which increases the risks of providing credit to them.

1.60 For all these reasons, we project that CPI inflation will ease to between $4^{1/2}$ - 5 per cent in 2016-17. We therefore think that the effective stance of monetary policy could be relaxed and in two ways. First, by easing liquidity conditions to make them consistent with the current policy rate (Box 1.7). Second, by further lowering the policy rate consistent with meeting the inflation target while supporting weakening economic activity and corporate balance sheets. Robust

measured growth of real GDP may not warrant an easing of monetary conditions. But a risk framework combined with a focus on the more reliable nominal aggregates is useful. If, in fact, real growth is weaker than suggested by the headline number, easing is appropriate. On the other hand, if real GDP growth is indeed robust, the implied disinflation is large, mitigating the inflationary risks of easing.

Figure 12: Tightness of monetary conditions -Difference between base rate and nominal GVA growth⁶ (per cent)



Source: CSO and RBI.

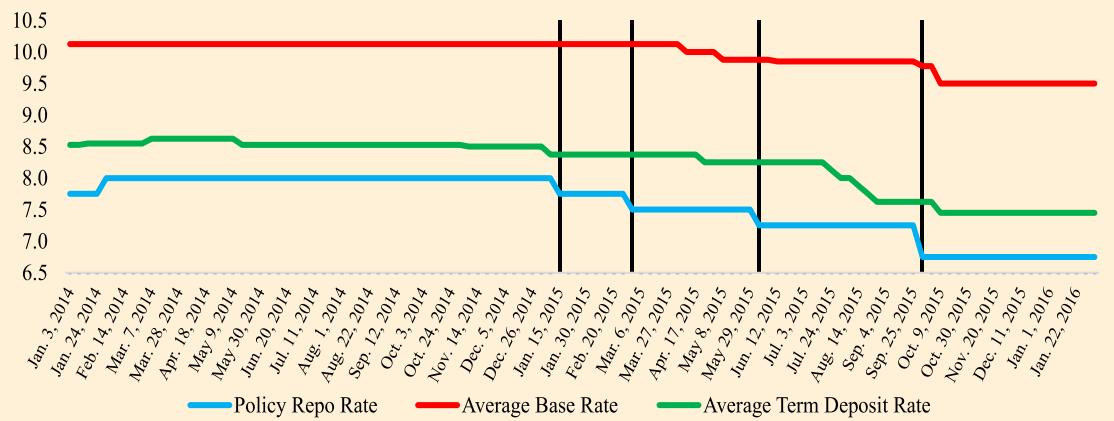
Box 1.7 What Explains the Incomplete Passthrough of Monetary Policy?

According to the February 2016 policy statement, the RBI has shifted to an accommodative policy stance. Without doubt, policy rates have been reduced substantially: in 2015, there were no less than four rate cuts cumulating to 125 basis points, including a 50 basis point cut at the October meeting. But there has been much less “accommodation” in bank lending rates, which have only fallen by around 50 basis points. What explains the failure of passthrough from policy rates to bank rates?

Figure 1 illustrates the transmission problem. It shows that the gaps between policy rates and bank rates have increased significantly over the past year. For example, deposit rates before the first rate cut were about 50 basis points higher than the policy rate, whereas now they are around 75 basis points higher. The lending rate spread, meanwhile, has increased by even more, from 200 basis points to 275 basis points.

Many commentators have emphasized that transmission is limited by high administered and small savings rates. The argument is that banks worry that if they cut their deposit rates, customers will flee to small savings instruments. Recognizing this, the government has reduced rates on some small savings schemes to make them more responsive to market conditions. But it is also clear from the chart that the small saving schemes don’t always constrain passthrough. For example, the June rate cut was followed by a large reduction in deposit rates whereas the much larger October cut was barely passed on at all. And the small saving schemes cannot explain why the reductions that have taken place in deposit rates have *not* led to commensurate reductions in lending rates.

⁶ The base rate for Q4 is taken to be the base rate for January 2016.

Figure 1: Movement of Repo Rate*, Base Rate & Term Deposit Rate

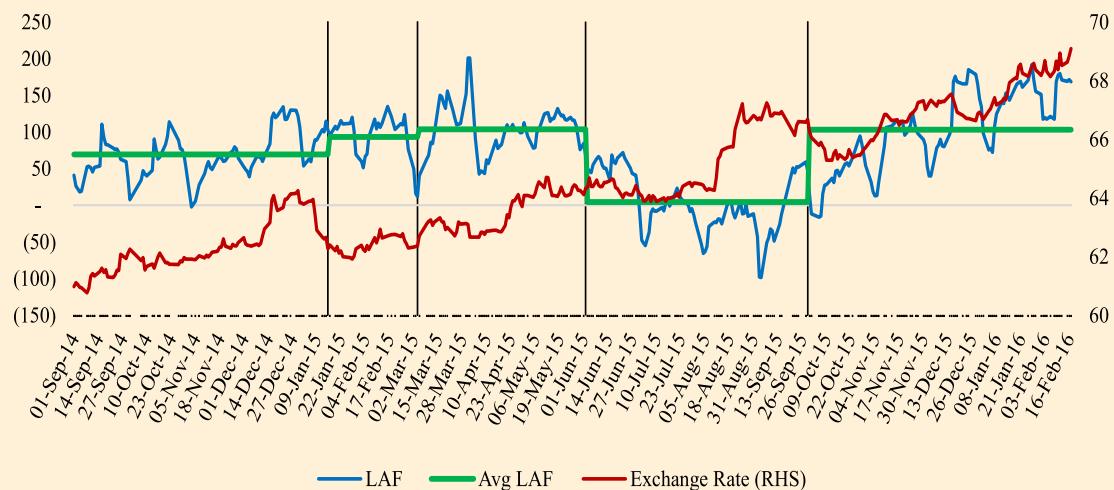
Source: RBI.

* Vertical Lines in all these boxes refer to dates when repo rate changes were announced.

It consequently seems that additional factors are at work. One possible factor could be changes in liquidity conditions as these can reinforce or negate the changes in policy rates. The reason is straightforward: if liquidity conditions are tight, commercial banks will be extra cautious about passing on policy rate cuts into lower deposit rates, for fear of losing customers and hence more liquidity.

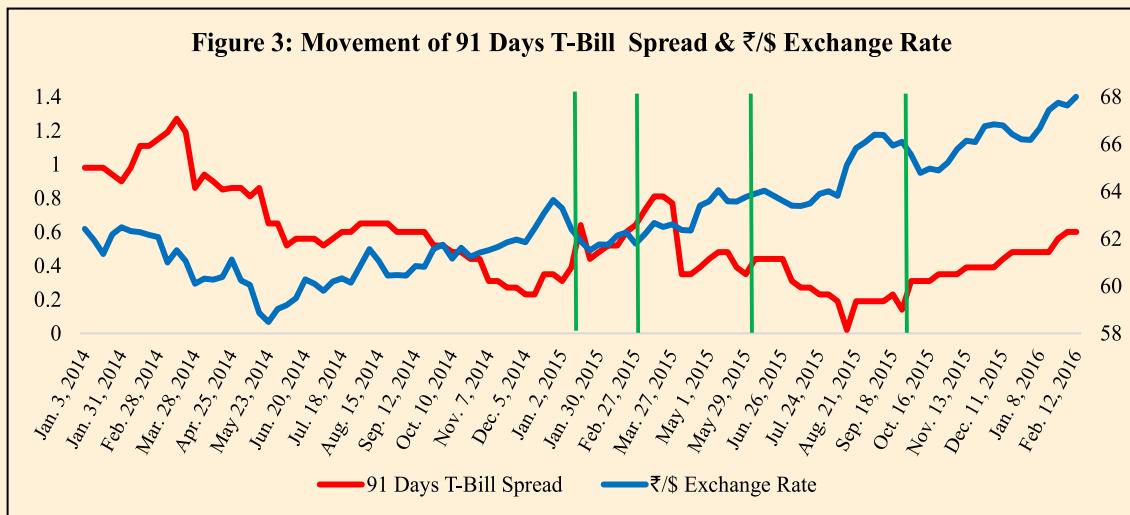
Figure 2 measures the tightness of monetary conditions in terms of quantities, plotting the RBI's provision of funds in the form of overnight and term repos (the "LAF" or Liquidity Adjustment Facility) in response to banks' demand for liquidity (The LAF is, by definition, a measure of the demand for liquidity). After the June rate cut, bank borrowing under the LAF fell to zero on average, in line with the RBI's strategy of easing its monetary stance. But around the time of the October cut, something changed: suddenly, banks began to borrow again, demanding an average of ₹1 lakh crore per day, rising to ₹1.75 lakh crore per day by February 2016.

Figures 3 and 4 show how the liquidity tightness has shown up in prices, that is to say short-term market interest rates most influenced by RBI policy. In the periods following the first three rate cuts, the spread between the 91 day t-bill rate and the repo rate declined. But it increased sharply starting in August and continuing after the October rate cut (Figure 3). Similarly, in the period following the first three rate cuts, the call money rate was below the repo rate, signalling easy liquidity conditions. After the October cut, that wedge has disappeared, signalling a tightening of liquidity (Figure 4).

Figure 2: Tightness of monetary conditions

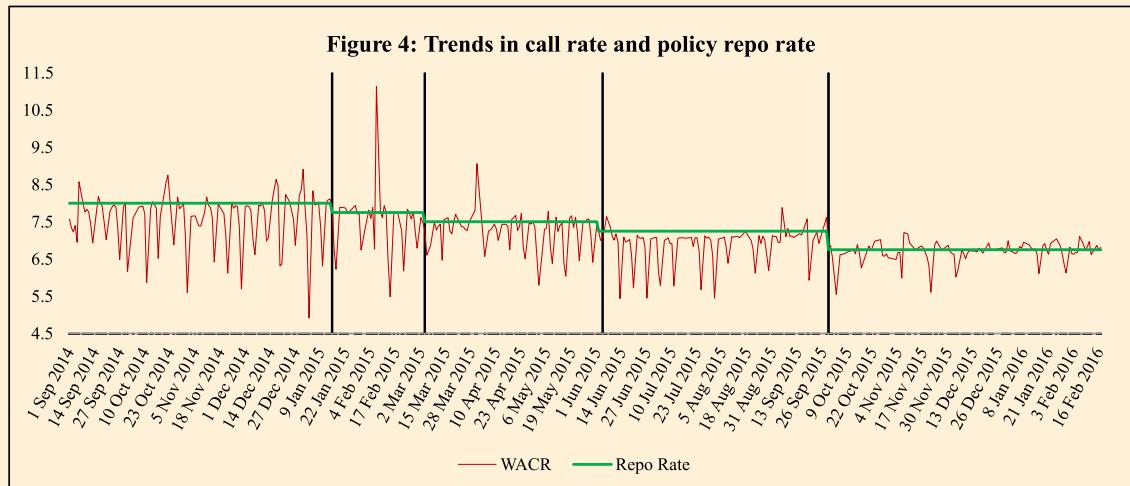
Source: RBI.

Contd....



Source: RBI.

What the quantity and price data suggest is that starting in late 2015 liquidity has been tightening even as policy rates have been cut. The consequence is that market interest rates and exchange rates are higher than otherwise, with implications for domestic growth, exports, and the health of the over-indebted corporate sector.



Source: RBI.

MEDIUM-TERM FISCAL FRAMEWORK

1.61 The 2016-17 fiscal stance needs to be assessed in two contexts. Most obviously, it needs to be evaluated against the likely short-term outlook for growth and inflation. At the same time, it also needs to be framed in a medium-term context. That's because the most fundamental task of budget policy is to preserve fiscal sustainability. The government needs to be in a strong position tomorrow to

repay the debts it is incurring today. And it needs to be seen to possess this strength.

1.62 Governments adopt various targets to achieve and signal fiscal sustainability. These include the overall deficit, the primary deficit, the revenue deficit, and the debt-to-GDP ratio. In principle, sustainable ratios are very much time, country, and history-contingent (Reinhart, Rogoff, and Savastano, 2003). But pinning down a relationship between

⁷ Reinhart, C., K. Rogoff, and M. A. Savastano, 2003, "Debt Intolerance", NBER Working paper No. 9908.

these contingencies and targets is difficult to do scientifically. Accordingly, countries often adopt targets established by others. For example, countries in other regions adopted targets of 3 percent of GDP for the fiscal deficit and 60 percent for the debt-to-GDP ratio as these had been adopted by Eurozone economies under the Stability and Growth Pact (SGP).

1.63 The clearest sign that a government is on a sustainable path is the direction of its debt-to-GDP ratio. If this ratio is declining, then the government's fundamental fiscal strength is improving. For much of the period since the 2008-09 the government has run large annual deficits in order to reflate the economy. Initially, the impediment was the large annual deficits that the government incurred as it sought to reflate the economy. These deficits were eventually curtailed, but macro imbalances nonetheless continued to grow, leading by 2013-14 to the second impediment: a sharp exchange rate depreciation that inflated the rupee value of foreign debts.

1.64 As a result, overall government debt continued to grow as fast as GDP, keeping the debt ratio of the consolidated government (Centre plus states) near 67 per cent of GDP. This ratio is high compared to some countries in Emerging Asia, India's credit rating peers. Accordingly, the government is determined to break the post-GFC trend, and finally put the debt ratio on a downward path toward more comfortable levels.

1.65 For this reason, there are strong arguments to stick to a path of aggressive fiscal consolidation as envisaged at the time of the last budget. Such a low deficit would not only curtail the debt accumulation, but would also offer some wider advantages. To begin with, it would mean that the government would be delivering on a commitment, thereby reinforcing its credibility, which is one of the most precious assets that any authority can command. Conversely, it is far from clear

why such a commitment would be abandoned when the economy is growing at more than 7 per cent. Such rapid growth would seem to provide ample revenues for the Budget, while enabling the economy to withstand the reduction in government demand. So, credibility and optimality seem to argue for adhering to the 3.5 percent of GDP target.

1.66 However, there are also arguments on the other side. With respect to feasibility, two factors complicate the fiscal task in 2016-17 and beyond:

- The Seventh Pay Commission has recommended that government wages and allowances be increased significantly. Full implementation of this pay award--which the government will decide on--would add about ½ percent of GDP to the Centre's wage bill.
- Public investment may need to be increased further to address a pressing backlog of infrastructure needs. Such an increase would merely return spending to its 2010-11 level of around 2 percent of GDP, well below the level in other emerging markets.

1.67 Taking these factors into account, the Centre's deficit could swell substantially. As a result, achieving the original could prove difficult unless there are tax increases or cuts in expenditures. There is some scope to increase receipts from disinvestment and spectrum auctions to realize which will require effort.

1.68 Second, even the desirability of a strategy of aggressive fiscal consolidation could be questioned. This is because the current environment is fraught with risks, which threaten all the engines of India's growth, as explained earlier. It would consequently seem important for the government to "purchase insurance" against these downside risks -- rather than reduce fiscal demand significantly and take the chance of precipitating their realization. Data uncertainty reinforces the

need for purchasing insurance.

1.69 But if the deficit target were to be relaxed, two questions would need to be answered. First, what would happen to interest rates? The lower the fiscal deficit, the lower the borrowing requirement, and possibly the lower the interest rate on government securities, which would be very helpful to companies facing debt servicing difficulties. International empirical research, however, suggests that the impact of deficits on long-term rates is typically small and uncertain. The reason for this is straightforward: long-term rates are basically determined by expectations of the future path of short-term rates. And this expected path typically depends largely on the long-term outlook for growth and inflation—and, not necessarily on the current year's fiscal deficit.

1.70 In India's case, the impact of fiscal deficits on long-term rates might be somewhat larger than elsewhere. That's because most government securities (G-secs) are held by banks, and banks have limited capacity to absorb bond supplies. This risk might seem particularly pertinent because over the past few years' banks have accumulated large holdings of G-secs, exceeding by a large margin the statutory liquidity ratio (SLR) minima that they are required to hold. Moreover, they will be acquiring sizeable amounts of state bonds over the next few years as bank loans to electricity distribution companies are securitized under the UDAY scheme. So, banks' appetite for additional bond issues might seem to be limited.

1.71 In fact, the risk of oversupply seems fairly small. For a start, a reduction in the fiscal deficit – even to one somewhat higher than 3.5 percent of GDP – implies a lower net bond issue, relative to GDP. And banks might actually be eager to purchase additional G-secs, since falling oil prices could lead to lower inflation, which could then lead to lower interest rates and capital gains on their

holdings. At the same time, foreign portfolio investors might also increase their purchases, since the RBI has been relaxing the limits on their G-sec investments. Conversely, if foreign inflows prove small, the RBI itself may need to buy G-secs to assure an adequate increase in money supply. Finally, if demand proves weak the government can always scale back its bond issues and instead run down its ample cash balances.

1.72 What about short-term interest rates? Isn't there a risk that large pay awards could push up inflation, forcing the RBI to increase their policy rate? As discussed above, the risk seems small, as there's little evidence that public sector pay increases are transmitted to prices, or even to wages in the private sector. In fact, the more significant risks to inflation would seem to be to the downside: from lower oil prices, a slowing Chinese economy, and the impact of fiscal deficit reduction – of any size – on aggregate demand.

1.73 Summing up the cyclical considerations, small differences in the degree of fiscal adjustment may not have much impact on interest rates. Which means that any positive effects from a large adjustment ("austerity") coming from lower interest rates could be offset by the direct negative impact on aggregate demand.

1.74 That still leaves the second issue: the need to put debt on a downward path. To see whether this would be possible with a more moderate pace of adjustment, a careful examination of the medium-term fiscal outlook is in order. The basic drivers of government debt can be specified precisely. Aside from exchange rate movements, which are unpredictable, the evolution of the debt-to-GDP ratio depends on two factors. These are: (i) the level of the primary deficit, that is, the fiscal deficit once interest costs are set aside; and (ii) the difference between the interest rate on government debt and the growth of nominal GDP (multiplied by the

previous year's debt ratio). In symbols:

$$d(t) - d(t-1) = p_d(t) + [i-g]/[1+g]*d(t-1)$$

1.76 Put simply, primary deficits push up the debt ratio. But nominal growth can bring it down, as long as the growth rate exceeds the interest rate on government debt. The primary deficit has been curbed to less than 1 percent of GDP in 2015-16, far below the nearly 3 percent of GDP recorded in 2011-12. But nominal growth has collapsed, as the GDP deflator has plunged to minimal levels, virtually eliminating the gap between growth and interest rates. And therein lies the problem.

1.76 The fiscal outlook consequently hinges on what will happen to the interest-growth differential. If it normalizes, the debt-GDP ratio could come down on its own, even without adjustment measures. For example, if nominal growth quickly recovers and averages 12 percent over the next five years (say, around 8 percent real and 4 percent inflation) while the effective interest rate on government debt stays near current levels, then consolidated debt could fall by $1^{1/2}$ percentage points of GDP over the next five years – even as states assume debts of around $2^{1/2}$ percent of GDP under the UDAY electricity reform scheme. Since the states would merely be recognizing an existing contingent liability, and bringing it onto their own balance sheet, a better measure of the underlying fiscal progress would perhaps be the reduction in debt, excluding UDAY bonds. This would be 4 percent of GDP (Figures 13 and 14).

1.77 It would be imprudent, however, to count on this scenario materializing. For one thing, adverse shocks have a way of throwing debt dynamics off course. The global recovery could falter. Inflation could turn out to be lower than expected. For these or many other reasons, the interest-growth

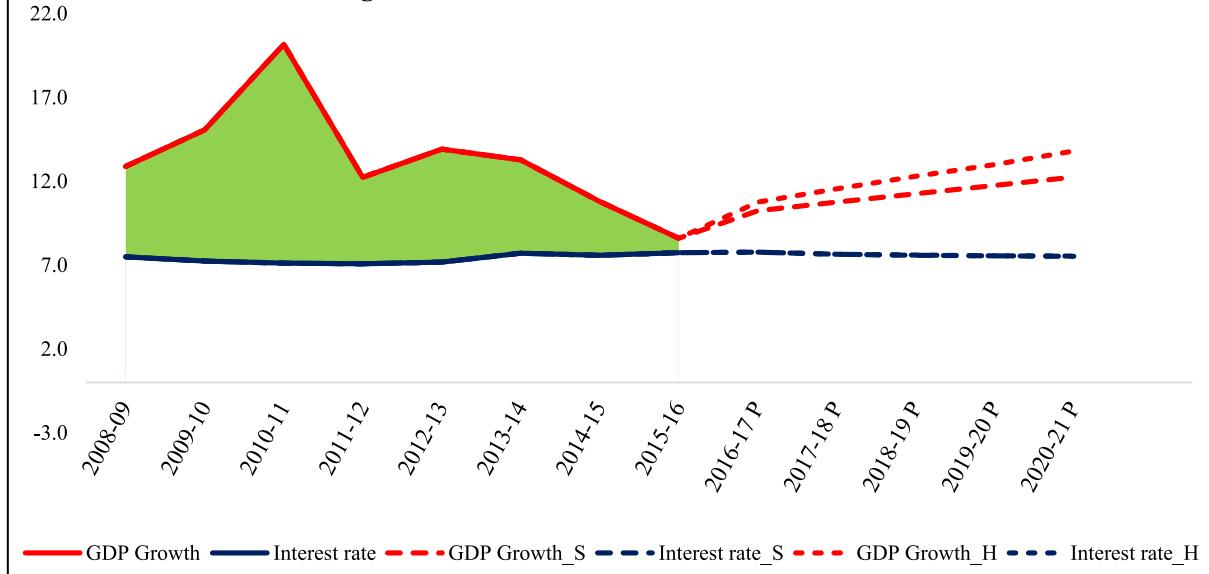
differential may not normalize anytime soon.

1.78 Consequently, a much more prudent approach would be to assume a more gradual recovery of nominal GDP, say one where nominal growth averages 11 percent over the next 5 years. In that case, the interest-growth differential would not be sufficient to bring down the debt—the primary deficit would need to be reduced. But if such a strategy were to be pursued, even modest and gradual adjustment could eventually make a significant difference. For example, if the fiscal deficit were reduced annually by around 0.2-0.3 percentage points of GDP, by the end of the period the overall deficit would be around 3 percent and the primary deficit would be essentially eliminated. Most significantly, the debt ratio would eventually—though not immediately—fall. Debt would decline by 2 percentage points of GDP in overall, and $4^{1/2}$ percentage points in underlying terms, slightly further than in the more favourable growth scenario (in Figure 14, this scenario would be very close to that shown as “Debt_H”). And of course if the economy responded to the fiscal prudence, as well as other structural reforms being pursued, and growth rebounded toward earlier levels, then the debt reduction would be even larger.

1.79 In sum, fiscal policy needs to navigate between Scylla and Charybdis. There are very good arguments for a strategy of aggressive fiscal consolidation, as earlier envisaged, and equally good arguments for a strategy of moderate consolidation that can place the debt on a sustainable path while avoiding imparting a major negative demand shock to a still-fragile recovery. The Union Budget will carefully assess these options.

1.80 In any event, the time is ripe for a review of the medium term fiscal framework. A medium-term perspective to expenditure

⁸ *d* refers to public liabilities of the general government; *pd* refers to primary deficit; *i* is the interest rate and *g* is the growth rate.

Figure 13: Growth-Interest Rate Differential

Source: CSO, RBI & projections.

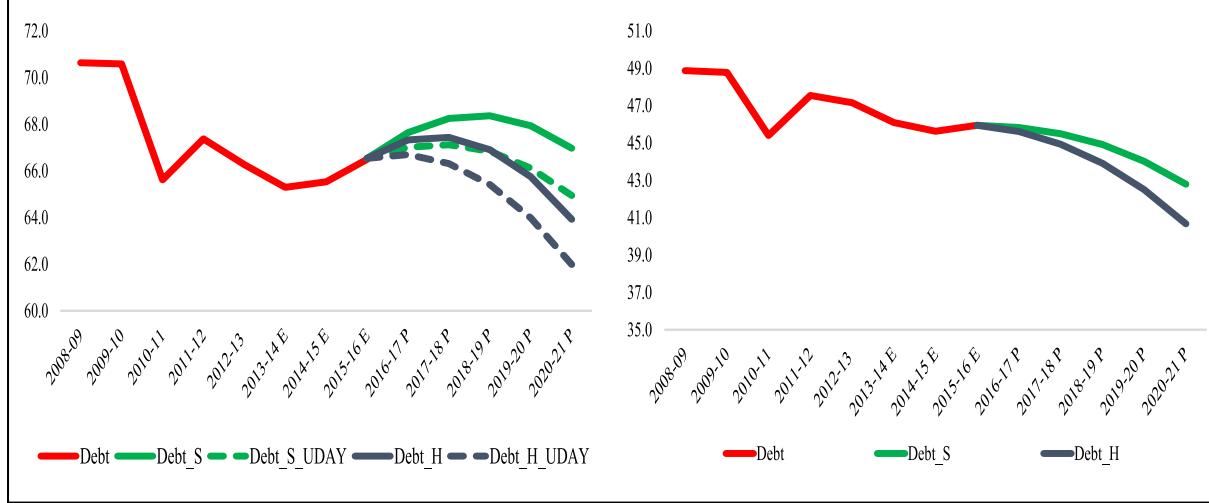
P=Projected

GDP Growth_S= Slower GDP growth forecast

GDP Growth_H= Higher GDP growth forecast

Interest rate_S= Projected interest rates under Slower GDP growth forecast

Interest rate_H= Projected interest rates under Higher GDP growth forecast

Figure 14: General Government and Central Government Debt Dynamics

Source: CSO, RBI, DMO, budget document and Projections.

E= Estimated

P=Projected

Debt_S= Debt under Slower GDP growth forecast

Debt_S_UDAY= Debt under Slower GDP growth forecast and without UDAY

Debt_H= Debt under Higher GDP growth forecast

Debt_H_UDAY= Debt under Higher GDP growth forecast and without UDAY

E= Estimated

P=Projected

Debt_S= Debt under Slower GDP growth forecast

Debt_H= Debt under Higher GDP growth forecast

planning is necessary. The fundamental growth and fiscal outlooks have changed considerably since the Fourteenth Finance Commission provided medium term revenue projections. And, above all, there are new developments in, and approaches to, medium term fiscal frameworks around the world from which India could usefully learn.

EXTERNAL OUTLOOK

1.81 Last year's Survey had identified a weak external environment as a major medium-term risk. It turned out to be a short run risk as well, and the prospects are that it might continue to be one in the period ahead.

1.82 One of the puzzles this year has been how remittances have held up despite a dramatic decline in oil prices and hence in the health of countries that host overseas Indian workers. (Figure 15). The Indian economy and foreign exchange earnings were buoyed by this non-decline in remittance flows. Still, prudence warrants monitoring this source of earnings because it is plausible that with oil prices remaining low in the near future, oil exporting countries will eventually be forced to curtail their use of foreign labour.

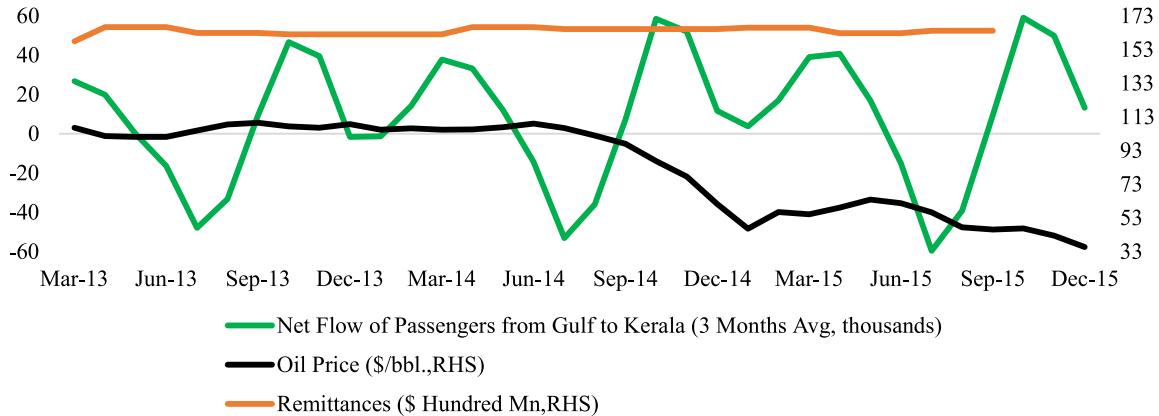
1.83 Overall exports declined by about 18 per cent in the first 3 quarters; much of this

was due to falling commodity prices but the decline in non-oil dollar exports and export volume was still sizable. Exports of commercial services remained stagnant in the first 3 quarters compared with an average growth of about 17 per cent during 2006-2011 (Figure 8). As a result, growth this year was held back—by about 1-1.2 percentage points relative to last year. A question—critical for assessing prospects going forward—is whether this recent export performance is explained mainly by a decline in global demand or a decline in competitiveness, related to the exchange rate or other factors.

1.84 It has been well documented that at the global level, trade has sputtered and more so than the world GDP. So, the question is whether India has fared worse than other exporters.

1.85 One can answer this question by examining how India's exports relative to world GDP have fared compared with world exports. Figure 16 plots four relationships: between India's exports of goods and world GDP (top left panel); between India's export of services and world demand (top right panel); and the two equivalents for the world (bottom panels). It is noteworthy that in the 2000s, India's exports of manufactured

Figure 15: Remittances and Air-passenger traffic from Kerala to Gulf



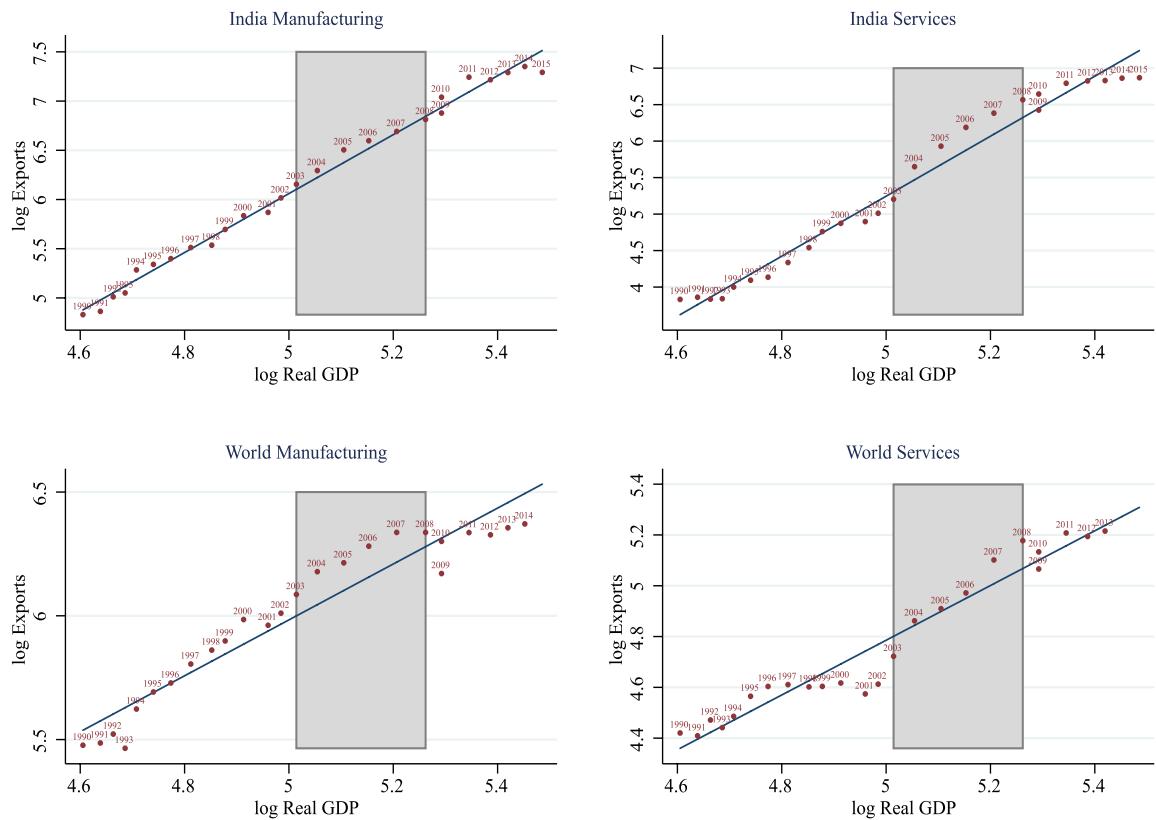
goods and services were above the line of best fit but note that services outperformed manufacturing (services data points are more above the line than manufacturing data points). For the world, there is a similar but less pronounced pattern, especially for services. In the last two years, however, Indian services exports have been more affected than Indian manufacturing exports and also world service exports.

1.86 Put differently, all the focus on manufacturing exports has distracted attention from what might be a no less noteworthy development. It is India's exports of services that has changed in the most significant, and perhaps alarming, way. One can see the problem looking at market shares. India's share of world exports of services, after surging in the mid-2000s, has flattened out.

1.87 What makes this development puzzling is that in recent years the composition of Indian exports of services is more favorable than that of Indian exports of manufactured goods. More of the former goes to the United States, and more of the latter to Asia. Since Asia has slowed down more rapidly, India's exports of manufactures should have been more affected. Furthermore, in the last year, the rupee has depreciated strongly against the dollar which should have helped India's exports of services.

1.88 These developments have longer-term implications. Realizing India's medium term growth potential of 8-10 per cent will require rapid growth of exports. How rapid this should be is suggested by comparing India's export performance in services with China's performance in manufacturing at a comparable stage of the growth surge.

Figure 16: Exports and world GDP



Manufacturing & Services Exports deflated using World Bank's Maufacturing Unit Value Index and US GDP deflator respectively.

Figure 17 plots China's global market share in manufacturing exports beginning in 1991, and juxtaposed on it is India's global market share beginning in 2003 when the shares were roughly similar. The magnitude of the challenge becomes evident when examining China's trajectory over the last fifteen years. To achieve a similar trajectory, India's competitiveness will have to improve so that its services exports, currently about 3 per cent of world exports, capture nearly 15 per cent of world market share. That is a sizeable challenge—and recent trends suggest that a major effort at improving competitiveness will be necessary to meet it.

TRADE POLICY

1.89 For decades, India's fundamental position on trade has been common across the political spectrum, shared by a wide range of intellectual opinion. But during this period the economy has changed almost beyond recognition. The non-success of the Nairobi WTO negotiations, the seismic shifts in the international trade architecture because of the emergence of mega-regional trade agreements, and a slowing world economy which creates pressures on domestic industry combine to present India with a great opportunity to collectively self-interrogate

on the national near-consensus.

1.90 Introspection is overdue on five issues:

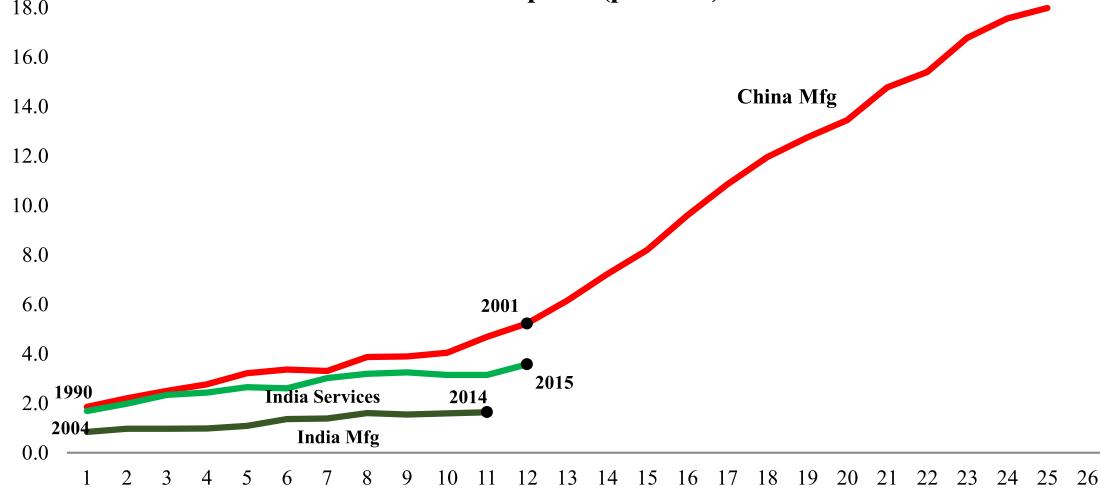
- Providing support to farmers in light of WTO rules;
- Mitigating the impact of erratic trade policy on farmer incentives;
- Reconciling the “big but poor” dilemma that confronts India in trade negotiations;
- Dealing with ongoing stresses brought on by the external environment; and
- Engaging more broadly with the world on trade.

Agriculture and the WTO

1.91 Start first with the two key issues in the Doha Development Agenda (DDA): the special safeguard mechanism (SSM) and food security/public stockholding both of which affect farmer interests.

1.92 The SSM embodies the right to impose trade barriers if there is a surge in agricultural imports into India. But there is one critical but overlooked question: to what extent does India really need SSM? In the Uruguay Round, many countries including India were allowed to set ceiling (jargon for very high) tariff bindings: that is, they were allowed to set, as their WTO obligation, high levels of

Figure 17: Share of India and China in world manufacturing and services exports (per cent)



tariffs which range from 40 per cent to 100 per cent (India's modal rate in agriculture) to 150 per cent. In a preponderance of tariff lines, there is a considerable gap between applied tariffs and the level of tariff bindings.

1.93 Once India had this freedom, it was not necessary to have safeguard actions because, in response to import surges, but even otherwise, India could raise tariffs up to the high level of bindings. Why then, for a long time, has India been asking for the right to impose SSMs, which is in effect asking for even more freedom to determine agricultural policies?

1.94 The answer is not very clear. As Table 2 illustrates, India's applied rate is less than 5 percent of the bound rate for about 4 percent of tariff lines, and less than 20 percent for about 16 percent of its tariff lines. So, India's only real need for SSM arises in relation to a small fraction of its tariff lines—some milk and dairy products, some fruits, and raw hides—where its tariff bindings are in the range of about 10-40 percent which can be uncomfortably close to India's current tariffs, limiting India's options in the event of import surges. But if that is the case, India should call for a discussion of SSMs not as a generic issue of principle but as a pragmatic negotiating objective covering a small part of agricultural tariffs. Perhaps, in this instance, lofty theologizing about freedom and sovereignty needs to cede to mundane haggling over hides and hibiscuses.

1.95 Take next the food security/stockholding issue. India had obtained a virtual cast-iron legal guarantee in 2014, which made the Bali Decision permanent and put it on a sound legal basis. This was reiterated in Nairobi. It remains open whether pressing for “permanent solution” is vitally necessary.

1.96 Especially at a time of farm stress, India must have the freedom to provide support to its farmers. The open question is

its appropriate level and form. The particular policies which are being defended are those that India intends to move out of in any case because of their well-documented impacts: decline in water tables, over-use of electricity and fertilizers (causing health harm), and rising environmental pollution, owing to post-harvest burning of husks. Moreover, the government is steadfastly committed to providing direct income support to farmers and crop insurance which will not be restricted by WTO rules.

1.97 The way forward on agriculture and the WTO can be thought of in the following conceptual terms. At the time of the Uruguay Round, India was a net importer of food and decided that it needed a lot of room to maintain “border protection” (tariffs in particular) and was less concerned about providing support to agriculture via domestic support (producer subsidies, minimum support prices etc). That was India's choice.

1.98 Twenty years on, India's position in agriculture has changed: it has become more competitive in agriculture and it now relies relatively more on domestic support (and less on tariff protection) for agriculture both to sustain domestic production and address low incomes for farmers. India's WTO obligations could predominantly be based on this domestic shift away from border protection to domestic support. India could consider offering reduction in its very high tariff bindings and instead seek more freedom to provide higher levels of domestic support: this would be especially true for pulses going forward where higher minimum support prices may be necessary to incentivize pulses production. This would be good for India, and India's trading partners should be more reasonable about accepting this shift.

Volatile Trade Policy

1.99 Agricultural policy, especially trade policy, is characterized by unusual volatility. The ups and downs are striking. Take the case

of cotton shown in Table 1A in the technical appendix of this volume. In 2010, there were ten changes in policy, mostly relating to exports, and often reversing previous actions. Look at the August 4, 2011 action compared with the action on March 31, 2011. There were then 5 changes in 2011, 5 in 2012 and 2 in 2014.

1.100 The view is that in agriculture, the interests of the producer and consumer have to be balanced. When world prices go up or there is domestic scarcity, export restrictions or bans are imposed; when the reverse happens, import tariffs are imposed. But this policy volatility actually ends up hurting farmers (of course) but eventually also consumers. This is because farmers produce less because of the policy volatility which results in reduced domestic availability and hence higher prices. Farmers are affected not only by the fact that on average they get less for their produce but even more so by the policy uncertainty that dampens, even chills, the incentive to produce. The notion that there is a trade-off between farmers and consumers is false except in the very short run.

1.101 Farm policy—minimum support prices and import and export policy—should be announced well in advance of the crop growing season and should not be altered during the course of the season unless there are exceptional developments.

Broader issues: The “Big-but-Poor” Dilemma

1.102 India also needs to address two broader issues. The first is what might be called the “big-but-poor” dilemma. On the one hand, India’s self-perception as a poor country translates into a reluctance to recognize and practice reciprocity (give-and-take) in trade negotiations. On the other hand, India’s policies have a significant impact on global markets and it has become a large economy in which partner countries have a legitimate stake in seeking market access—just as India

should in relation to its partners’ markets.

1.103 The latter means that partners expect India to play the reciprocity game: “you open your markets and/or you reduce your freedom to protect in return for us doing the same.” If the WTO is not to be consigned to irrelevance—in the wake of the big trading countries turning decisively away from it towards regional agreements—there is only one way forward: in return for similar actions by its trading partners, India, China and other similar countries must be willing to offer to open up their markets and undertake greater commitments in the context of future WTO negotiations.

1.104 In the 1970s and 1980s, India’s engagement in the WTO was broadly non-reciprocal. This was possible because was small enough for trading partners to overlook this non-reciprocity. Today they do care because of India’s market size, and India must respond, balancing the “big-but-poor” dilemma.

1.105 Partner countries must show a serious interest in reviving multilateralism. Equally India and other emerging market economies must make it attractive for trading partners to engage in the WTO. An important part of this will require India playing more of the reciprocity game and using its growing markets as leverage to attain its own market interests abroad, including the mobility of labor.

1.106 The costs of reluctant engagement need careful review. The US and others are negotiating agreements (the Trans-Pacific Partnership (TPP)) that have excluded India and hence shaped in a way that do not take into account India’s important interests (the rules on intellectual property are a good illustration). If and when India joins these agreements, it will be not on India’s terms but on terms already cast in stone, terms that India could not influence because of being perceived as not engaging fully.

Dealing with ongoing stresses

1.107 Trade policy is under stress also for reasons related to the ongoing turmoil in the international environment. Global demand is weak, and one of the powerhouses of trade in recent times—China—is slowing down. Chinese slowdown has important implications for India. As the Chinese currency weakens, setting in train reactions from other countries, India's external competitiveness across-the-board will come under pressure. But there will also be sectoral impacts. Chinese excess capacity in commodity-related sectors such as steel and aluminum will lead to a surge in imports into India.

1.108 How should India respond? India should resist calls to seek recourse in protectionist measures, especially in relation to items that could undermine the competitiveness of downstream firms and industries. India could respond in three ways. First, the most effective instrument to respond to threats to overall competitiveness is the exchange rate. The rupee's value must be fair, avoiding strengthening. This can be achieved through some combination of monetary relaxation, allowing gradual declines in the rupee if capital flows are weak, intervention in foreign exchange markets if inflows are robust, and being cautious about any further opening to inflows that could unduly strengthen the rupee.

1.109 Second, India should strengthen procedures that allow WTO-consistent and hence legitimate actions against dumping (anti-dumping), subsidization (countervailing duties), and surges in imports (safeguard measures) to be taken expeditiously and effectively. Ineffective domestic procedures risk becoming the excuse for broad-based protectionist actions.

1.110 Third, India should eliminate all the policies that currently provide negative protection for Indian manufacturing and favor foreign manufacturing. This could be achieved by quick implementation of the GST as recommended by the recent report of the GST Committee. If delays are envisaged, a similar result could be achieved by eliminating the countervailing duty exemptions.

Broader issues: Prerequisites for Trade opening

1.111 Underlying all these proximate issues is a much deeper problem: can trade liberalization be a source of efficiency, dynamism and growth not just for services but also agriculture and manufacturing going forward?

1.112 To put it in the terms that Rodrik and Subramanian (2004) used to describe India's reforms of the 1980s and 1990s: is India really pro-competition or is it just pro-business?⁹

1.113 Every country, and every constituency in every country, wants more exports. But there is much more ambivalence about imports. The efficiency effects of trade, however, work through imports: by exposing domestic industry to greater competition and by creating incentives domestically to move resources toward export sectors.

1.114 Now, it is intrinsic to creating greater competition that there will be churn, stress, and dislocation, necessitating some exit of uncompetitive firms and industries. Accepting the transitory costs of trade liberalization and providing a cushion against them—in the form of targeted assistance—will be necessary for India to be able to negotiate credibly in the WTO today and, if India so decides, the Trans-Pacific Partnership (TPP) tomorrow. That is why, the government's

⁹ Dani Rodrik and Arvind Subramanian, *From Hindu Growth to Productivity Surge: The Mystery of the Indian Growth Transition*, NBER Working Paper No. 10376.

Skill India and Make in India initiatives are so important. Greater trade opening will increase the size of the pie but it must be combined with assistance in the transition phase to make everyone better off.

1.115 In some ways, that ambivalence about

greater foreign competition, stemming in turn from the domestic politics of disruption and exit, is at the heart of India's difficulties with the WTO, trade agreements, and trade policy more broadly (as discussed in Chapter 2). There is no getting away from it.

Table 2: India's Actual and Bound Rates in Agriculture (Per cent)

Bound minus applied	No. of tariff Lines	Cumulative tariff Lines	Percentage	Cumulative
0	21	21	1.6	1.6
1-5	20	41	1.5	3.1
6-10	136	177	10.4	13.5
11-20	39	216	3.0	16.4
21-30	109	325	8.3	24.7
31-40	354	679	26.9	51.7
41-60	111	790	8.4	60.1
61-80	235	1025	17.9	78.0
81-100	101	1126	7.7	85.7
Above 100	188	1314	14.3	100.0
Total	1314			

Source: WTO.