India's Dream Run, 2003-08
Understanding the Boom and Its Aftermath

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From 2003, the Indian economy enjoyed a boom in growth for five years. The economy grew at a rate close to 9% per year, until it was punctured by the financial crisis of 2008. What explains that boom? Did the sustained liberal reforms finally pay off? Or was it a debt-led, cyclical boom, coinciding with an exceptional phase in the world economy? This paper contends that it was the latter case, driven by private corporate investments, financed by rising domestic savings, and topped by unprecedented inflows of foreign capital – leaving behind heightened corporate leverage, and frothy asset markets.

As the global economy faces a semi-slump and precarious macroeconomic balance, how to reverse the current slowdown is at the crux of the discourse on India's policy paralysis. With the corporate sector mired in over-leverage, perhaps the most credible policy options now available are to step up public infrastructure to boost investment demand, and expand bank credit on easy terms to the informal sector and agriculture – which were throttled during the boom years – so as to ease supply constraints.

The web version of this article corrects a few errors that appeared in the print edition.

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1 Introduction

India's dream run in the economy lasted for five years, with close to 9% average annual growth rate between 2003-04 and 2007-08 – one of the world's highest in this period, close behind China's growth rate (Table 1, col 5, p 40).[1] After the financial crisis in 2008, growth in the following two years was largely restored by (i) liberal credit at low interest rates, and (ii) expanding public expenditure, reversing the fiscal consolidation by raising the fiscal deficit from 2.5% of gross domestic product (GDP) in 2007-08 to 4.8% in 2011-12 (*Economic Survey* 2011-12). As the stimuli tapered off, growth has faltered: Central Statistical Office's (CSO) advance estimate for 2012-13 is, in fact, as low as 5%.

At the heart of the recent (popular) dispute on "policy paralysis" are the competing perspectives on what the boom was all about, and how the dream run can be restored: Was it a virtuous outcome of sustained market-oriented reforms? Or was it just a cyclical credit boom, boosted by a surge in foreign capital inflows, coinciding with an unprecedented turnaround in world trade – only to be punctured by the financial crash? Ignoring the crisis as a blip, protagonists of the former view argue for moving ahead with structural reforms to restore growth. For many others, the crisis was a wake-up call against the perils of unbridled capital inflows (the adverse effects of which India has fortuitously escaped, at least so far); they argue for safeguarding the domestic economy and institutions against the vagaries of financial globalisation. Furthermore, perceiving growth to be demand-constrained after the collapse of the external markets and contraction of investment demand, proponents of the latter view call for mobilising domestic resources and institutional strengths to revive the home market.[2]

To begin with, it is worth reiterating that the slowdown after the crisis is relatively modest, similar to China's (Figure 1, p 40). India's financial sector, perhaps the only one other than Canada's, warded off the crisis due to sound regulation and macro-prudential norms. Applauding the boom, it is worth recognising that such growth episodes of four to seven years' duration have not been uncommon in recent times; yet not all (or most) of them get translated into trend accelerations, as growth reversals are more typical than popularly believed or remembered.[3]

This study, therefore, seeks to discern what the boom was all about and its proximate causes. Such an effort could contribute to a more reasoned and realistic diagnosis of the reasons for the slowdown, and the options available for reviving growth. Anticipating the findings, the study's principal arguments are stated below.

2 The Argument

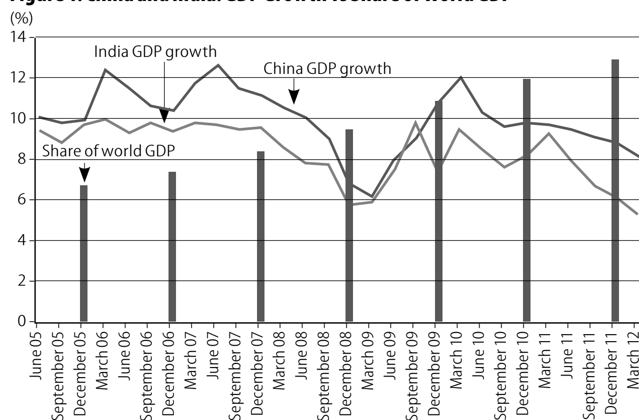
The dream run was a (private) corporate debt-led growth that until the 2008 crisis tapped into an exceptional rise in the world trade. Unlike the conventional consumption-led boom-and-bust cycles, this one was led by investment financed by domestic savings, boosted by an unprecedented influx of foreign private capital. The investment-saving gap rose to 2.3% of GDP by 2008 – compared to less than 1 percentage point of GDP in five years prior to the boom. Total private capital inflows – that is, the sum of foreign direct investment (FDI), foreign portfolio investment (FPI) and foreign currency convertible bonds (FCCBs) – rose to a phenomenal level of nearly 10% of GDP by 2007-08. Apparently, easy global monetary conditions boosted capital inflows; credit supply at low interest rates encouraged risky investments, raised corporate debt sharply, and also perhaps contributed to a steep rise in stock and real estate (asset) prices. Export growth has now collapsed with the world economy mired in the Great Recession, and corporate investment demand has contracted under adverse macroeconomic stress. Hence, output growth has decelerated. How then to revive the growth?

Table 1: Growth Rates of GDP and Principal Sectors, 1991-92 to 2007-08, at 1999-2000 Prices

	Economic Activity	Percentage Shares in GDP		Average Annual Growth Rates			
		1990-2000	2007-08	2003-04/ 2007-08	2008-09/ 2010-11	1991-02/ 2002-03	1991-02/ 2007-08
1	2	3	4	5	6	7	8
1	Agriculture and allied	25.0	17.9	5.0	2.7	2.3	3.1
2	Mining and quarrying	2.3	1.9	4.7	4.5	4.2	4.3
3	Manufacturing	14.8	16.0	10.0	7.2	5.7	7.0
	3.1 Registered manufacturing	9.7	11.2	10.8	8.5	6.4	7.7
	3.2 Unregd manufacturing	5.1	4.9	8.4	4.6	4.5	5.7
4	Elec, gas and water	2.5	2.2	7.5	4.6	6.2	6.6
5	Construction	5.7	7.0	12.4	6.8	5.2	7.3
	Industry	25.3	27.0	9.9	6.7	5.5	6.7
6	Trade, hotel and restaurants	14.2	16.3	10.2	7.5	7.6	8.4
7	Transport and communications	7.5	11.1	13.6	13.4	8.6	10.1
	7.1 Railways	1.2	1.1	8.3	8.0	3.9	5.2
	7.2 Other transport	4.6	5.3	10.2	7.0	7.4	8.2
	7.3 Communications	1.6	5.3	24.2	28.0	18.1	20.0
8	Finance, insurance and real estate and business services	13.1	14.8	10.6	10.6	7.8	8.6
	8.1 Banking and insurance	5.9	7.3	12.8	13.3	9.6	10.5
	8.2 Real estate, business services	7.2	7.7	9.1	8.4	6.7	7.4
9	Community, social and personal services	14.9	12.8	5.8	9.7	6.1	6.0
	9.1 Pub ad and defence	6.9	5.2	4.6	13.1	5.5	5.3
	9.2 Other services	8.1	7.6	6.7	7.3	6.6	6.6
	Services (6+7+8+9)	49.7	54.9	9.8	10.1	7.3	8.0
	GDP	100	100	8.9	7.8	6.0	6.5

Source: *National Accounts Statistics*, various issues.

Figure 1: China and India: GDP Growth vs Share of World GDP



Source: *The Financial Times*, 3 June 2012.

With explicitly protectionist laws like "Buy America" enacted by the Obama administration in the US, which accounts for the bulk of outsourcing[4] and is India's second-largest export market, the external demand is unlikely to be recaptured without a new "business model", or until new markets are found for capital- and skill-intensive exports. Mired in deep debt, private corporate investment is unlikely to revive anytime soon, as high interest rates and a depreciating currency have raised debt servicing costs. Considering the poor state of investment demand and the uncertainty in world financial markets, a further easing of rules for capital inflows is most likely to attract short term, volatile funds that are unlikely to finance long term, productive, investment. Instead, it is only likely to add more froth to asset markets – preventing realistic valuations and liquidation of excess inventory.

Therefore, reviving public infrastructure investment seems a better bet as it would "crowd-in" private investment and demonstrate a policy commitment to growth – perhaps the most credible measure to win the confidence of all stakeholders. The consequent rise in the fiscal deficit and inflation is likely to be self-liquidating in the medium term as aggregate supply improves. A gradual aligning of domestic energy prices with international prices would eliminate the largest source of subsidies. Food and consumer goods inflation could be kept in check by boosting bank credit to agriculture and small businesses, which were ignored during the boom.

The rest of this paper is structured as follows: Section 3 describes the Indian economy just before the boom (in other words, the "initial conditions"); Section 4 documents the boom in the real sector (that is, output, savings, investment and employment), seeking to discern what lies behind the much-vaunted "growth story". Section 5 explains the financing of the boom, by looking at credit growth, including private capital inflows and their implications; and how excess lending in good times has apparently contributed to potentially adverse consequences later on. Summarising the main findings, Section 6 concludes by weighing the policy options available.

3 The Initial Conditions

In the early years of the first decade of this century, yearly inflation was moderate (at 3.5%), the trade deficit was 2.8% of

GDP, and the current account balance (as a proportion of GDP) was in surplus and rising from 0.6% in 2001-02 to 1.2% in 2002-03 (Table 2). Oil prices were low and stable. Commercial banks preferred investing in government paper well beyond statutory requirements, due to lack of credit demand or bankers unwilling to take credit risk (or both). Similarly, the domestic investment rate was lower than the savings rate. In other words, the macroeconomic conditions were largely benign; yet output was expanding well below the trend growth rate of 3.8%, continuing the deceleration that had set in during 1996-97.

Table 2: The Initial Conditions

	1999-2000	2000-01	2001-02	2002-03
Annual GDP growth rate	6.4	4.4	5.8	3.8
Inflation rate (GDP deflator)	3.9	3.3	3.0	3.8
Trade balance (% of GDP)	(-) 4.0	(-) 2.7	(-) 2.4	(-) 2.1
CAD (% of GDP)	(-) 1.0	(-) 0.6	(+) 0.7	(+) 1.2
Domestic saving rate (% of GDP)	24.8	23.7	23.5	26.3
Fixed investment rate (% of GDP)	25.5	24.6	24.3	25.4
Private corporate fixed investment (% GDP)	8.0	6.9	6.7	6.4
International oil prices (in $)	30.3	25.9	26.1	31.1

Sources: (1) RBI: *Handbook of Statistics on Indian Economy* (various issues), and (2) Thomson Reuters.

With public investment curtailed as a matter of policy and with low private investment demand, FDI was seen as a saviour. FDI approval was sizeable (mostly for power generation) but the actual (or realised) inflow was about a third of the approval, mostly in manufacturing (Nagaraj 2003). Foreign investment in the power sector was severely discredited after the debacle of Enron's Dabhol power project in Maharashtra. The bursting of the dot-com bubble, and the decline (briefly) in software export growth after the "Y2K" problem was fixed apparently reversed the flow of software professionals for a while.

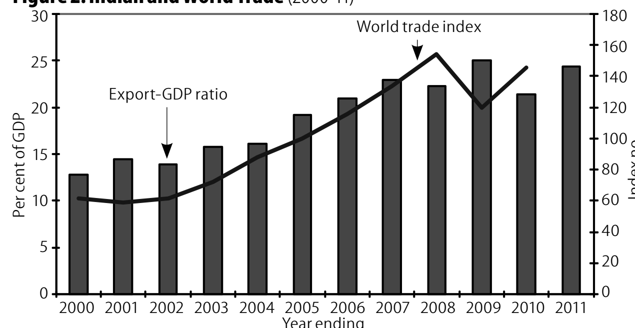
The most visible infrastructure investment was the "Golden Quadrilateral" road reconstruction effort, initiated in 2000, to upgrade road connectivity between the four metropolitan cities – perhaps the largest public investment programme in recent times – which, with a lag, contributed to the boom in the automotive industry and private road transportation. Liberal reformists pressed for more deregulation to revive growth, though until then the experience did not bear out their confidence, especially as the memory of the Asian financial crisis was too fresh to accept a benign view of external financial reforms.

But things began to look different around 2003:

(1) World trade, dormant after the Asian financial crisis, turned around to grow at an unprecedented rate of 16.5% annually between 2003 and 2008 – against 3% per year in the previous six years, and at the highest six-yearly average growth rate ever achieved since 1980. As India's exports are known to be pro-cyclical, the exports-to-GDP ratio almost doubled – from 14% in 2002 to 25% in 2009 (Figure 2).

(2) Seizing the opportunity of the communications revolution, the US liberalised the rules for outsourcing, hailed as the next industrial revolution, contributing to the boom in the back office operations of the leading financial firms (Blinder 2006). The social capital, or the social network, of Indian professionals working in Wall Street firms, Indian academics in US universities and Indian entrepreneurs all combined to create a remarkable

Figure 2: Indian and World Trade (2000-11)



Source: WTO website and RBI's *Handbook of Statistics on Indian Economy, 2011-12.*

success story, igniting the popular imagination of India becoming the world's back office.

(3) Capital flows to emerging market economies that had practically dried up after the Asian financial crisis, more than doubled in five years, from $250 billion in 2002 to about $600 billion in 2007, largely determined by global supply factors, such as the low US interest rates after the dot-com bubble burst, and the willingness of global investors to take risks in investing in emerging market economies (Ghosh et al 2012; Institute of International Finance 2012). As the US and Japan maintained a loose monetary policy to revive their domestic economies, international investors grabbed the opportunity to invest in emerging markets, via carry trade, to profit from interest rate arbitrage.

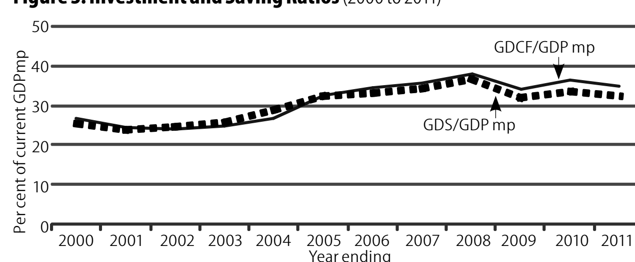
(4) The dilution of the definition of an "FDI-invested company" in India to comply with the International Monetary Fund's (IMF) guidelines, and the enlargement of the scope of such investment in real estate and special economic zones (SEZs) in 2004 and 2005 were other important factors (more about these later).[5]

4 Boom in the Real Sector

Industry and services grew at close to 10% annually during the boom (Table 1, col 5).[6] How was this growth financed? Domestic savings rates shot up by 11 percentage points of GDP at market prices (GDPmp), from about 26% in 1999-2000 to 37% by 2007-08 (Figure 3). Improved profitability boosted corporate savings; tax reforms improved revenue collection, and public sector enterprises' better financial performance turned around public savings (Nagaraj 2008). In 2007-08 the savings-investment gap exceeded 2 percentage points of GDP, and was financed by external resources.

As noted earlier, outsourcing from the US created demand for IT and ITES; merchandise exports grew at 25% annually

Figure 3: Investment and Saving Ratios (2000 to 2011)



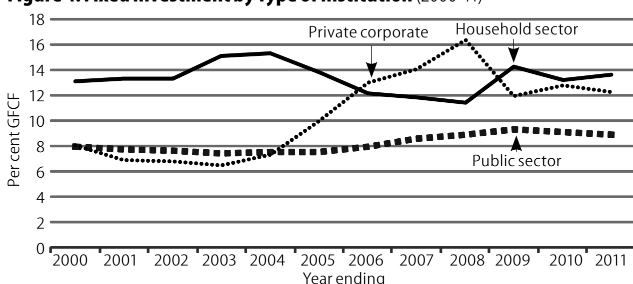
Source: CSO (2011); CSO (2012)
RBI's *Handbook of Statistics on Indian Economy, 2011-12.*

Table 3: GFCF by Industry, 1980-81 to 2007-08 (at constant prices, % of GFCF)

Sectors	Year				
	1980-81	1990-91	2000-01	2007-08	2010-11
1 2	3	4	5	6	7
1 Agriculture and allied activities	20.2	14.4	9.5	7.1	8.0
2 Mining and quarrying	3.2	5.4	1.6	4.5	3.9
3 Manufacturing	22.3	27.4	30.6	34.6	29.9
3.1 Registered manufacturing	12.7	18.8	20.4	28.6	24.1
3.2 Unregistered manufacturing	9.7	8.6	10.2	6.0	5.8
4 Electricity, gas and water	11.0	12.0	8.5	5.8	6.0
5 Construction	1.1	1.3	1.7	6.0	4.8
6 Trade, hotel and restaurant	3.9	3.3	2.8	6.6	8.8
7 Transport and communications	10.9	10.5	15.9	6.5	8.1
7.1 Railways	2.6	2.0	1.2	1.3	1.3
7.2 Other transport	6.9	6.0	9.4	3.1	3.3
7.3 Communications	1.3	2.5	5.3	2.6	3.4
8 Finance, insurance, real estate and banking	10.1	12.4	17.5	12.7	13.7
8.1 Banking and insurance	0.5	1.3	1.4	0.8	0.7
8.2 Real estate, business services	9.6	11.0	16.1	11.9	13.0
9 Community, soc, and personal services	17.4	13.4	11.9	16.3	16.7
9.1 Public administration and defence	14.9	10.4	7.8	8.9	10.1
9.2 Other services	2.5	3.0	4.1	7.3	6.7
Total GFCF/GDP ratio	21.5	23.9	24.6	36.7	34.8

Source: *National Accounts Statistics*, various issues.

Figure 4: Fixed Investment by Type of Institution (2000-11)



Source: *National Accounts Statistics*, various issues.

during the boom; software exports and telecom services also grew at the same rate. Construction and commercial real estate expanded to meet the IT industry's requirements, boosting industrial demand. Thus, prima facie, it was a virtuous cycle of external markets and capital inflows reinforcing one another to grab a new market opportunity created by the technological revolution and deregulation (more on capital inflows later). As Indian firms acquired the competence and confidence to operate in international markets, they leveraged the easy credit conditions to penetrate external markets by acquiring factories and firms across the developed economies, contributing to FDI outflows from India (Nagaraj 2006; Nayyar 2008).

The boom, however, had many causes for concern.

4.1 The Narrow Base

Though output expansion seemed widespread, ranging from manufacturing to financial services, on a closer look the bulk of the incremental output came from a few narrowly defined industries and services, like the automotive industry, and telecoms and business services in the tertiary sector (Nagaraj 2008).[7]

4.2 Private Corporate Boom

For the first time, the private corporate sector (PCS) became the economy's investment engine; the corporate sector's contribution to domestic output, as per official statistics, went up from 19.4 in 2003-04 to 25% in 2007-08.[8] The investment share of the household sector declined and that of the public sector remained roughly constant during the boom (Figure 4). Abundant credit at low interest rates reduced the cost of capital, boosting investments and profits. The public sector's share in domestic output fell from 24.6% in 2003-04 to 19.9% in 2007-08, despite the public sector's improved return on capital employed contributing to public savings.[9]

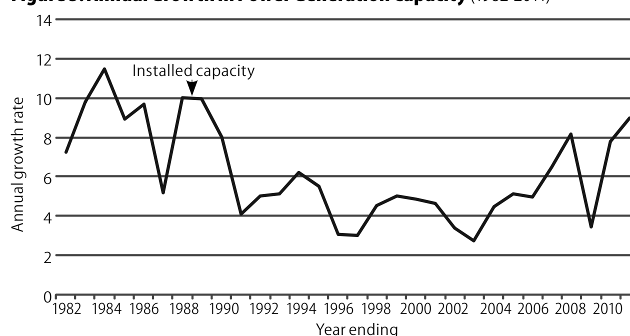
4.3 Investment Composition

The fixed investment rate, or gross fixed capital formation (GFCF), went up during the boom to 36.7% of GDP in 2007-08, taking India close to east Asian levels (Table 3, col 6). By industry of use, most of the incremental investment went into registered manufacturing, whose share in GFCF rose by 8 percentage points, from 20.4% in 2000-01 to 28.6% in 2007-08, though its share in domestic output stagnated around 15% of GDP, implying a rise in capital intensity or growing excess capacity, or both.

During the boom, by type of assets, construction's share in total GFCF declined from 55.8% in 2003-04 to 52.5 in 2007-08, but its composition underwent some notable changes. During the same period, residential construction's share in total construction declined by 5.7 percentage points, despite a significant rise in the share of bank credit for private housing (sweetened by fiscal sops) (Table 4, col 2, p 43). Non-residential construction's share went up by nearly 12 percentage points, to 58.4% in 2007-08, from 46.6% in 2001-02. So, the much visible boom in construction was in fact mostly driven by commercial real estate, partly in response to the demand from outsourcing firms.

Despite the policy commitment – as exemplified by Bharat Nirman – infrastructure's share in GFCF (defined as (i) electricity, gas and water, and (ii) transport, storage and communications) rose merely by 2 percentage points: from 20.2% in 2003-04 to 22.2% in 2007-08. Contrary to popular perception, the expansion of infrastructure in physical terms remained modest. Though an uptick in the installed capacity of power generation is discernible, the long-term deceleration observed since 1981 has nevertheless persisted (Figure 5).[10]

Figure 5: Annual Growth in Power Generation Capacity (1982-2011)



Considering the policy commitment, one would expect to see a sharp rise in the share of road construction in GFCF. While the modernisation of the national highway network, starting in 2000, has made considerable progress, the share of fixed investment accruing to "other transport" (which includes

Table 4: Share of Construction in GFCF and Its Components (by type of asset, at constant prices, in %)

Fiscal Year Ending	Construction' Share in GFCF	Share in GFCF in Construction		
		Residential Construction	Non-Residential Construction	Other Construction
1	2	3	4	5
2000	52.9	20.0	47.7	30.8
2001	54.6	19.9	46.6	31.7
2002	54.9	18.6	47.5	32.3
2003	55.9	17.8	50.2	31.0
2004	55.8	17.0	52.0	30.3
2005	55.2	15.4	55.5	29.1
2006	54.6	13.9	56.1	30.0
2007	53.6	12.9	56.0	31.1
2008	52.5	11.3	58.4	30.4
2009	52.2	12.3	56.0	31.7
2010	52.3	11.6	57.6	30.7
2011	52.8	11.1	58.3	30.5

Source: *National Accounts Statistics*, various issues.

roads) has, in fact, shown a slight decline. Moreover, the progress of the rural road connectivity programme – called the Prime Minister Gram Sadak Yojana (PMSYJ) – during the boom was poor; but it improved subsequently.[11]

Thus, while the headline numbers of output and investment growth during the boom are impressive, on a closer look, their compositions leave many reasons for concern.

4.4 Effect on the Labour Market

Employment expansion and rise in real wages or, simply put, the labour market outcomes, make up the true test of the distributional consequences of economic growth. Soon after the financial crisis, as manufactured exports dwindled, employment in labour-intensive industries fell. The Labour Bureau's surveys of such industries in the organised sector during 2008 and 2009 amply bear this out. However, as the majority of employment in these industries is in the unorganised sector, the real brunt of the crisis on labour would have been a multiple of what is reported in these surveys (http://www.labourbureau.nic.in/reports.htm; accessed on 10 January 2013).[12]

National Sample Surveys (NSS) on employment and unemployment confirm these outcomes: manufacturing employment declined by 3.7 million (6.6%) between 2004-05 and 2009-10, with women accounting for the bulk (84% or 3.1 million out of 3.7 million) of the job losses. Most of the jobs were in industries such as textiles, leather and diamond cutting, in the industrialised states of Gujarat and Tamil Nadu (Thomas 2012). Registered (or factory) manufacturing, which, as noted above, attracted the bulk of the incremental fixed investment during the boom, nevertheless witnessed a turnaround in employment, reversing the decline during the first half of the decade (Goldar 2011).

What were the economy-wide employment effects of the boom? There are no official statistics that strictly coincide with the boom period. The closest approximation is the NSS results between 2004-05 and 2009-10, which show the following: despite an unprecedented output expansion, employment did not grow; labour force participation rates (which includes employed as well as employed labour) declined, especially for women – at a time when population grew at 1.7% annually. However, real wage rates rose across the sectors (Rangarajan et al 2011).

What does one make of these findings? Rangarajan et al (2011) suggested that they represent a virtuous outcome of the boom: rapid economic growth raised the real wages, enabling women to withdraw from the labour force to look after their families, and put their children into schools. Neat and appealing though, such an explanation seems faulty for the simple reason that the proportion of rural women dropping out of the labour force is far greater than those getting into education. Looking closer at the evidence, Kannan and Ravindran came to the opposite, yet seemingly more plausible, conclusion: "…there has been hardly any increase in total workers [employed] despite an annual gross domestic product (GDP) growth of over 8% and a population growth of 1.74% adding 98.12 million people between 2004-05 and 2009-10" (Kannan and Ravindran 2012: 77). Their accounting exercise showed that the labour force declined by 52 million, of which only 45% went into education, they were mostly men, 83% of those who dropped out of the labour force were rural women. The picture is also roughly similar for the decline in the workforce (Table 5, p 44). Thus, Kannan and Ravindran conclude: "…our exercise does not support the hypothesis that the withdrawal of women could be due to improved economic conditions" (p 80).

To sum up the findings of this section: during the boom, the manufacturing and services sectors grew at about 10% annually, but growth was concentrated in a few industries and services; the output growth was largely based on the private corporate sector. Domestic savings mostly financed the investment boom, the bulk of which went into registered manufacturing, while infrastructure's share barely increased, despite avowed policy commitment to the contrary. Despite an uptick in power generation capacity, its long-term decelerating trend has changed only marginally. While the modernisation of the national road network seems satisfactory (though delayed), rural road construction's record was dismal during the boom, but improved somewhat later on. The share of non-residential construction expanded at the expense of residential construction. There was practically no economy-wide growth in employment; manufacturing employment contracted by 3.3 million, mainly in labour-intensive industries, as the external markets collapsed, though organised manufacturing employment turned around.

5 Financing of the Boom

The dream run, we contend, was the outcome of a surge in bank credit to the private corporate sector, boosted by a flood of foreign capital, consisting of the three streams of inflows noted earlier. But, after the Lehman Brothers' collapse, the credit markets, expectedly, turned frigid, following the pattern observed in classic credit cycles.

5.1 Flow of Credit

During the boom, bank credit to the commercial sector (as a proportion of GDP), shot up from about 35% to 50%, and the share of non-food bank credit went up even more – at a rate

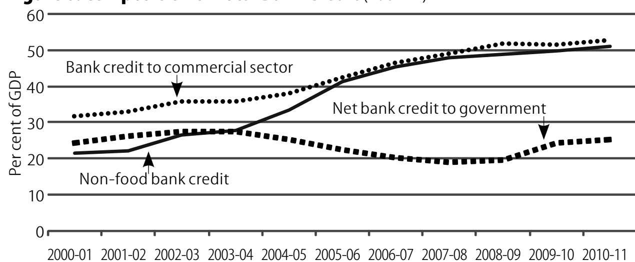
Table 5: Accounting for the Decline in Labour Force and Workforce in (2009-10, in million)

	Male	Female	Total
A Decline in labour force			
1 Decline in labour force	12.81	38.83	51.65
2 Decline due to education	12.75	10.46	23.20
3 Decline due to other than (2)		28.37	28.45
4 Share of those in (3) belonging to rural areas (%)		83.00	
B Decline in workforce			
1 Decline in workforce	13.07	39.93	53.00
2 Decline due to education	12.75	10.46	23.21
3 Net decline after deducting (2)	0.32	27.47	29.79
4 Additions to activity status 92 and 93	0.17	29.19	29.36
5 Residual	0.15	0.28	0.43

Activity status 92 = attended domestic duties only; activity status 93 = attended domestic duties along with free collection of goods (vegetables, roots, firewood etc), sewing, tailoring, weaving, etc, for household use.
Source: Kannan and Ravindran (2012).

much faster rate than the growth in fixed investment (discussed in the previous section); correspondingly, the share in bank credit to government declined as public investment's share contracted, restricting the fiscal deficit (Figure 6). In principle, one expects the credit flow to broadly mirror the pattern of fixed investment growth. But that does not seem to

Figure 6: Composition of Total Bank Credit (2001-11)

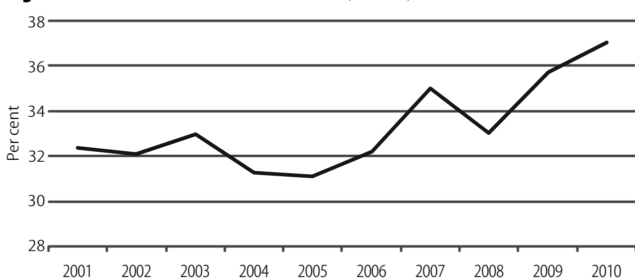


Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12*.

be the case, as credit seems to have grown disproportionately faster. So, where did the incremental credit go? It perhaps went into the following avenues:

(1) The private corporate sector's share in total bank credit went up from 31% in 2004-05 to 37% of GDP in 2009-10 (Figure 7).

Figure 7: PCS' Share on Total Bank Credit (2001-10)



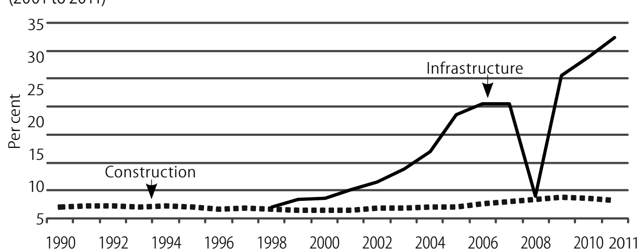
Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12*.

(2) Infrastructure (defined as power, telecoms and roads, as per banking statistics) secured a phenomenal rise in credit: from 9% of total bank credit in 2003 to 33.5% in 2011 (with a dip in 2008, when the credit markets froze) (Figure 8).

(3) The share of personal loans in total bank credit went up from 13% in 2000-01 to 23% in 2005-06 (Figure 9), with a little over half of it going into housing mortgages.

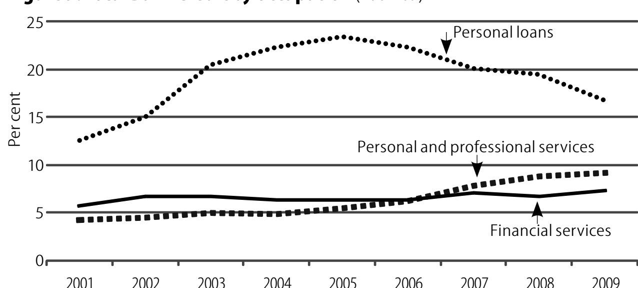
(4) The remaining 50% of consumption loans fuelled the growth in consumer durables and automobiles, boosting industrial growth.

Figure 8: Construction and Infrastructure's Share in Bank Credit (2001 to 2011)



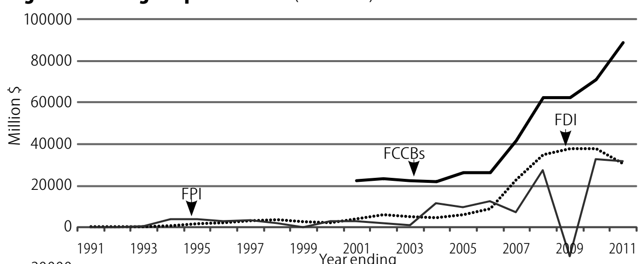
Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12*.

Figure 9: Total Bank Credit by Occupation (2001-09)



Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12*.

Figure 10: Foreign Capital Inflows (1991-2011)



Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12*.

In other words, the credit boom mainly benefited PCS, infrastructure, and residential housing. However, other industries' share in fixed investment did not go up proportionately. As discussed in the previous section, most of the incremental fixed investment went into registered manufacturing, but its share in total bank credit, in fact, declined by 12 percentage points during the boom, from 56% to 44%. How can these two observations be reconciled? Two probable reasons can be advanced: one, given the scale of the expansion in bank credit, manufacturing industries were not deprived of funds; two, since credit is fungible, a growing share of it plausibly got diverted for non-productive purposes, into stocks, land and real estate, boosting asset prices.

5.2 Foreign Capital Inflow

In 2003-04, almost the entire gross capital formation was financed domestically. Foreign savings, on average, barely constituted 1% of GDP in the five years prior to the boom. But, by 2008-09, the savings-investment gap had risen to 2.3% of GDP, which, in itself, is not a high figure historically. What is of concern is the astounding amount of capital that actually flowed into the economy. Figure 10 depicts total capital inflows (sum of FDI, FPI and FCCBs), which bring out the surge during the boom and the sudden withdrawal of FPI in 2008. In fact, FCCB

Table 6: Aggregated Ratios for 12 Select Companies from 8 Corporate Groups (%)

	2008-09	2009-10	2010-11	2011-12
Interest coverage	2.91	2.76	2.43	1.7
Debt to EBITA	6.96	7.32	7.24	9.46
Debt to equity	1.21	1.23	1.38	1.89

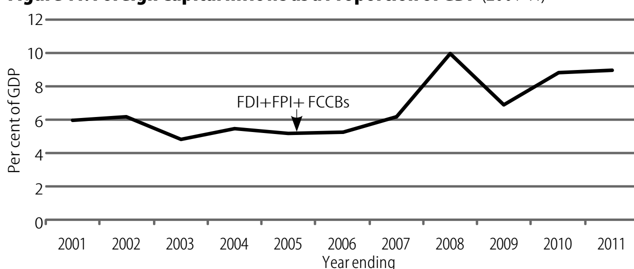
(1) EBIT – Earnings before interest and taxes.
EBITDA – Earnings before interest, taxes, depreciation and amortisation.
Source: RBI: *Financial Stability Report*, 2012, p 17.

Table 7: Growth in Debt of Corporate Groups between 2007 and 2012 – An Illustrative List

Group Companies	Debt as on (in Rs Crore)		Compound Annual
	2006-07	2011-12	Growth Rate (in %)
Lanco group	1,700	29,300	76
Adani group	4,400	69,500	74
GVK group	1,700	21,000	65
Vedanta group	9,500	93,500	58
GMR group	3,700	32,900	55
Jaypee group	8,100	45,400	41
Videocon	6,300	27,300	34
Essar	24,600	93,800	31
Reliance	26,100	86,700	27
JSW	13,200	40,200	25
Total debt of 10 groups	99,300	5,39,500	40
Banking system loans	1,75,7000	42,89,700	20

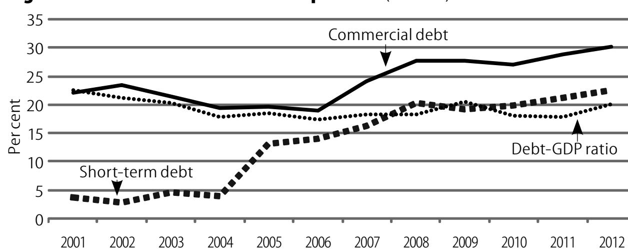
The table is based on a report by Credit Suisse Group AG.
Source: Bhuma Srivastava, Livemint, 21 August 2012.

Figure 11: Foreign Capital Inflows as a Proportion of GDP (2001-11)



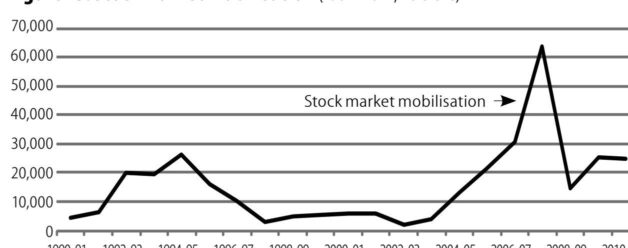
Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12*.

Figure 12: External Debt and Its Composition (2001-12)



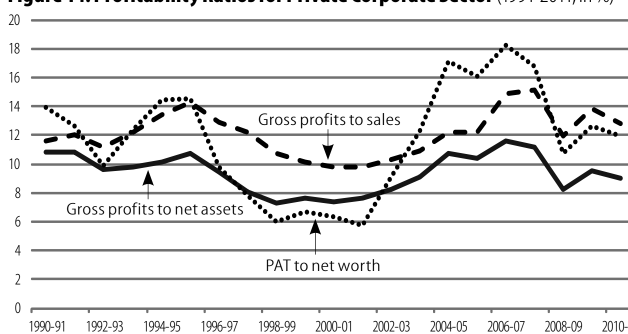
Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12*.

Figure 13: Stock Market Mobilisation (1991-2011, Rs crore)



Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12*.

Figure 14: Profitability Ratios for Private Corporate Sector (1991-2011, in %)



Source: RBI's company finance statistics.

inflows continued until 2011. Moreover, as Figure 11 shows, the sum of these inflows, as a proportion of GDP, reached 10% in 2007-08 – that is, over four times the savings-investment gap. Trade credit (shown as short-term debt) also swelled during the boom (Figure 12). However, these inflows did not give rise to concerns about debt repayment, as government's external borrowing had reduced proportionately.

Expectedly, FPI was invested in the stock market, both the primary and the secondary. IPOs (new capital issues by non-governmental companies) rose from a meagre Rs 1,878 crore in 2002-03 to an unprecedented figure of Rs 63,638 crore in 2007-08; that is, as a percentage of current GDP, from 0.1% to 1.4%; thereby reducing the cost of capital drastically (Figure 13). Other things remaining the same, easy money boosted corporate profitability (Figure 14): the ratio of profit after tax to net worth doubled from 9.1% in 2002-03 to 18.2% in 2006-07.

What explains the surge in capital inflows? As argued earlier, the loose monetary policy followed in the US to revive the domestic economy after the dot-com bubble burst, and Japan's near-zero interest rates around the middle of the first decade of this century led to a resurgence of capital outflows to the emerging markets, with investors prepared to take greater risks in search of higher returns. Further, domestic rules concerning the definition of FDI underwent significant changes, namely:
(1) Dilution of the definition of "FDI invested company" from 40% equity capital to 10% (to comply with IMF guidelines). It meant that investments by private equity/venture capital/hedge funds (PE/VC/HF) could automatically get qualified as FDI.
(2) Permission granted to count reinvested capital and acquisition of existing factories and firms as FDI; to enter construction and real estate, in 2005, with up to 100% equity ownership (http://dipp.nic.in/English/Policies/pn2_2005.pdf; accessed on 9 January 2013); and, to invest in SEZs, in 2005 (http://commerce.nic.in/pressrelease/pressrelease_detail.asp?id=1390; accessed on 10 January 2013).

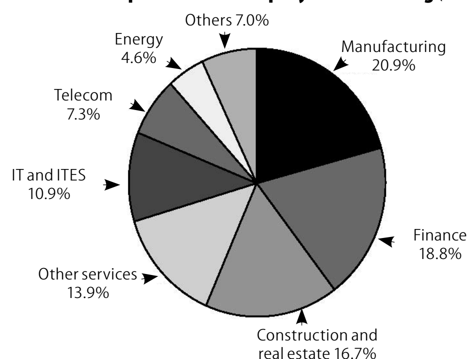
Is the enlargement of the scope of FDI to include such investments justified in economic terms? Probably not, if one goes by the motivation of FDI. To quote the OECD definition: "direct investment relationships, by their very nature, may lead to long-term and steady financing and technology transfers with the objective of maximising production and earnings of the MNE [multinational enterprise] over time" (as quoted in Rao and Dhar 2011).

Internationally, PE/VC/HF are counted as part of "shadow banking" (broadly defined as private non-deposit-taking financial firms), whose sources of funds and activities remain opaque, as they are lightly regulated entities. Going by the

OECD definition, these sources do not qualify as FDI, but by following the IMF's criterion of 10% equity cut-off limit, they do. As India has followed the IMF definition, a growing share of these funds has come to qualify as FDI, with potentially adverse implications for the economy.[13]

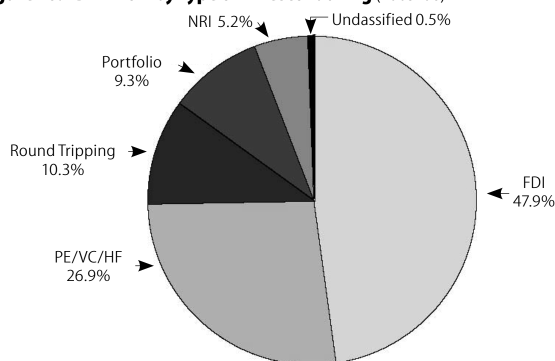
The foregoing changes in the rules netted a ninefold rise in FDI inflow in five years – from $4.3bn in 2003-04 to $37.8bn in 2007-08. Where were these resources invested, and what were the implications for the economy? Rao and Dhar (2011) have offered a credible answer, by carefully piecing together the official information from a variety of published sources for 2,748 FDI projects, each of at least $5 million, accounting for 88% of the inflow, from September 2004 to December 2009. The following are the main findings:

Figure 15: Sectoral Composition of FDI Equity Inflows during (2005-08)



Source: Rao and Dhar (2011).

Figure 16: FDI Inflow by Type of Investor during (2005-08)



Source: Rao and Dhar (2011).

(i) Only about 40% of FDI went into manufacturing, telecom, energy and IT and ITES, which, could, in principle, have brought in technology to augment productive potential (Figure 15). (ii) The share of FDI going in for acquisitions went up from 15.5% in 2000-01 to 40.3% in 2006-07. (iii) Similarly, in the light of the above discussion, when classified by type of investor, a little less than half of the capital inflow can be called genuine FDI that could, in principle, bring in long-term capital with the potential of technical spillover (Figure 16). (iv) But nearly 40% of the inflow consisted of PE/VC/HF and portfolio investment that are essentially short-term funds. (v) About 10% of the FDI represented "round tripping" – that is, domestic surplus routed back into the economy via tax havens (like Mauritius) to earn tax-free returns.[14]

If the above analysis is correct, then only two-fifths of the much-vaunted FDI, in principle, went into augmenting the productive potential; the rest acquired existing assets or recycled domestic resources to earn tax-free returns.

As the flood of foreign capital coincided with the new SEZ policy, corporate houses (large and small) and real estate firms with easy access to credit have apparently rushed to amass "land banks".[15] That asset prices have skyrocketed across the country during recent years, and have stayed at high levels despite the slowdown after the financial crisis (and the decline in corporate profitability) vindicates our suspicion that these markets are largely propped up by such external funds (more on this later).[16]

Abundant credit at low interest rates in a stable macroeconomic environment boosted business expectations and led promoters to chase over-optimistic investment projects, as often is the case in episodes of debt-led growth. Though Indian stock markets boast of a large number of listings – about 5,000 quoted companies in 2010 in the Bombay Stock Exchange, with the aggregate market capitalisation exceeding the size of GDP – in reality, the market is narrow and shallow, with only a small number of shares actively traded. Moreover, as most large companies are owner or promoter-controlled, trading in the secondary stock market often leaves little scope for contestability of managements – the principal source of profit for private equity funds.

Since such foreign funds, seeking managerial control by hostile takeover bids, were apparently frustrated in their efforts, they probably went after newer, and relatively smaller, enterprises and unlisted companies, when such investments were permitted (http://rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=174, accessed on 10 January 2013).

Private equity capital, in particular, apparently discovered an opportunity in these investments, which could be termed "predatory lending".[17] On the flip side, promoters of many Indian firms sought to leverage such foreign funds to leapfrog into the big league, overlooking the downside risks of high costs of external debt in terms of domestic currency (when market conditions turned adverse).

5.4 Bursting of the Boom

As the credit market froze worldwide after Lehman Brothers collapsed, foreign portfolio investment, expectedly, fled for the safety of the dollar (Figure 10). But the effect in the financial markets was luckily limited and short-lived, since Indian financial entities had hardly invested in the sub-prime securities (due to stricter regulation).

The foregoing account of the capital inflows seems consistent with what Eichengreen and Mitchener described as "credit boom going wrong". To quote them:

> As the economy expands, banks and financial markets provide an expanding volume of credit to finance the growth of both consumption and investment, particularly where regulation is lax and competition among bank and non-bank financial intermediaries is intense. Whether because the exchange rate is pegged or for other reasons such as a positive supply shock, upward pressure on wholesale and retail prices is subdued. Hence, the central bank has no obvious reason to tighten and stem the growth of money and credit, leading to a further expansion of output and further increase in credit.

> Higher property and securities prices encourage investment activity, especially in interest-sensitive activities like construction. But, as lending expands, increasingly risky investments are underwritten. The demand for risky investments rises with the supply, since, in the prevailing environment of stable prices, nominal interest rates and therefore yields on safe assets are low. In search of yield, investors dabble increasingly in risky investments. Their appetite for risk is stronger still to the extent that these trends coincide with the development of new technologies, in particular, network technologies of promising but uncertain commercial potential.
> Eventually, all this construction and investment activity, together with the wealth effect on consumption, produces signs of inflationary pressure, causing the central bank to tighten. The financial bubble is pricked and, as asset prices decline, the economy is left with an overhang of ill-designed, non-viable investment projects, distressed banks, and heavily indebted households and firms, aggravating the subsequent downturn (Eichengreen and Mitchener 2003: 2-3).

That the capital inflows during the boom seem to have followed an unmistakable path of past episodes of debt-led growth is also evident from the following perceptive observation by Calvo et al (1996: 124):

> ...[L]arge capital inflows can also have less desirable macroeconomic effects, including rapid monetary expansion, inflationary pressures, real exchange rate appreciation and widening current account deficits. Hence, a surge in inflows of the magnitudes seen in recent years may pose serious dilemmas and tradeoffs for economic policy, especially in the present environment of high capital mobility.
> History has also shown that the global factors affecting foreign investment tend to have an important cyclical component, which has given rise to repeated booms and busts in capital inflows. For example, in Latin America, marked episodes of capital inflows during the 1920s and 1978-1981 were followed by major economic crises and capital outflows, such as in the 1930s and in the mid-1980s. The Mexican balance-of-payments crisis of December 1994 is but a recent example of this phenomenon and highlights the vulnerability of developing capital-importing countries to abrupt reversals; thus, an aim of policy is to reduce that vulnerability.

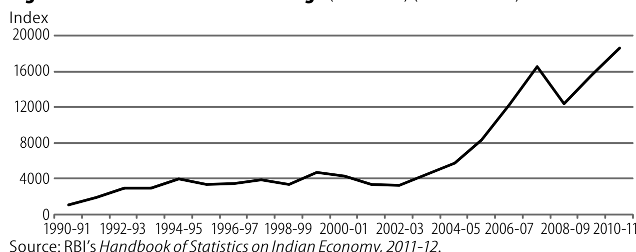
The credit cycle also seems to echo Minsky's financial instability hypothesis:

> The financial instability hypothesis is a model of a capitalist economy which does not rely upon exogenous shocks to generate business cycles of varying severity. The hypothesis holds that business cycles of history are compounded out of (i) the internal dynamics of capitalist economies, and (ii) the system of interventions and regulations that are designed to keep the economy operating within reasonable bounds (Minsky 1993: 8).

In the light of the foregoing, it is amply evident that what India faced was, in fact, a typical credit boom, with its source of finance sowing the seeds of its own destruction. The stimulus provided a breather, however; the fiscal deficit by going up and public savings by declining helped prop up the economy for the next two years (that is, 2010 and 2011).[18] But, with the continuation of the Great Recession in the developed world, external demand has now tapered off; growth seems to be reverting to a rate between 5% and 6% per year.

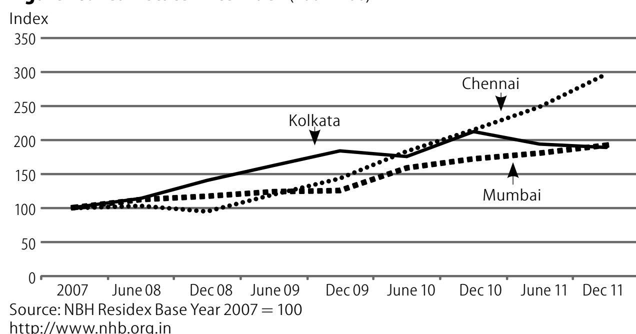
Yet, surprisingly, the secondary stock market rebounded quickly after the crisis to surpass the pre-crisis peak (Figure 17), despite the collapse of the primary stock market and the decline in corporate profitability. Likewise, property prices have remained high, despite the reported decline in actual sales (Figure 18).[19] What could explain these high asset prices?

Figure 17: BSE Sensex Annual Average (1991-2011) (1978-79=100)



Source: RBI's *Handbook of Statistics on Indian Economy, 2011-12.*

Figure 18: Real Estate Price Index (2007=100)



Source: NBH Residex Base Year 2007 = 100
http://www.nhb.org.in

As argued earlier, one could reasonably suspect that the unprecedented capital inflows and the deep-pocketed foreign institutional investors – the latter now control nearly 40% of freely traded stocks in Indian bourses – could have helped sustain the high asset prices.

However, the chickens are now coming home to roost as the cost of servicing the debt has shot up due to (i) high interest rates, (ii) currency depreciation, and (iii) output slowdown. The RBI's recent *Financial Stability Report* endorses such a proposition (Table 6, p 45). It said:

> An in-house analysis of 12 holding companies (where accounts of all subsidiaries carrying out various projects of the corporate group is consolidated) belonging to 8 large corporate groups15 with high exposure to infrastructure sector was carried out. Eight out of 12 companies witnessed compound annual growth rate of over 30% in debt over 2007-08 to 2011-12. For all these 12 companies taken together, the interest coverage has gone down, whereas their debt to EBITDA and debt to equity ratios have gone up during the last four years. These corporates seem to be more vulnerable as compared to their counterparts in the same industry (RBI 2013).

Heavily indebted firms are now grappling to renegotiate debt repayment schedules. As FCCBs – which usually have a 3-4 year tenure – are maturing, borrowers are seemingly trying every trick in the rulebook to retain managerial control, while foreign creditors press for their pound of flesh. Distress sales of productive assets are increasingly being made to cash-rich firms (example: Kishore Biyani selling off some of his consumer brands to the Aditya Birla group company, Madura Mills). What we are now witnessing with Kingfisher Airlines, Deccan Chronicle, Biyani's Big Bazaar or DLF seems emblematic of the downside risks of over-leveraged growth trajectories.

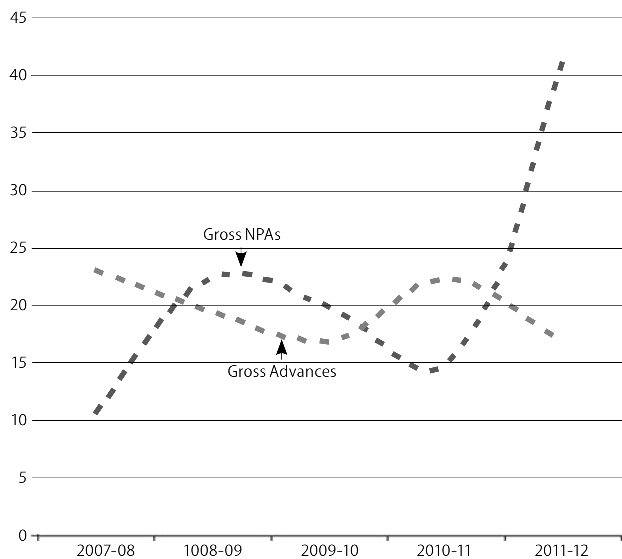
Table 7 (p 45) provides an illustrative list of the big corporate groups with a burgeoning debt burden (a combination of domestic as well as foreign debt). Over the six years between 2006-07 and 2011-12, the debt of these corporate groups as a whole went up at an annual compound growth of 40%, twice

the growth rate of total bank lending. The default of Suzlon Energy on its $200 million FCCB issue is likely to create ripples in the financial markets worldwide, denting the credibility of the private corporate sector.[20] Apparently, a large part of foreign borrowing remains unhedged risk, which continues to pose systemic threats. To quote the RBI report once again to buttress our observation:

> Unhedged foreign exchange exposure of corporates is a source of risk to them as well as to the financing banks and the financial system. Large unhedged forex exposures have resulted in accounts becoming Non-performing Assets (NPAs) in some cases. Banks were, therefore, advised in February 2012 that they should rigorously evaluate the risks arising out of unhedged foreign currency exposure of the corporates and price them in the credit risk premium while extending fund-based and non-fund-based credit facilities. From the information submitted by banks, it is observed that a significant portion of foreign exchange exposures remained unhedged in the recent period. This is especially disquieting given that the exchange rate volatility has been higher in India in comparison to other emerging market currencies as well as those of advanced economies (RBI 2012: 10).

Corporate sector delinquencies, in turn, are raising the banking sector's non-performing assets, adversely affecting its profitability, and reducing its lending potential (Figures 19 and 20). RBI's *Financial Stability Report* stated as much: "Restructuring of loans, particularly of big ticket loans under the corporate debt restructuring (CDR) mechanism, has recently come under closer scrutiny due to the steep rise in the number and value of such advances. Of late, the growth in restructured advanced has outpaced the growth in gross advances of the banking system" (RBI 2013: 1).

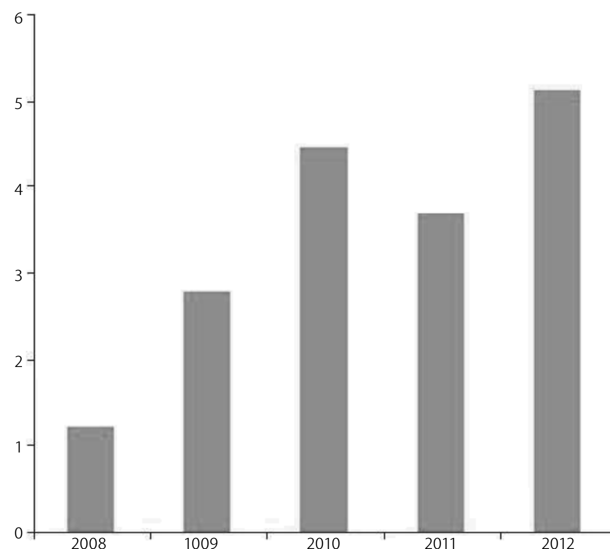
Figure 19: Growth in Banking Sector's NPAs vis-à-vis Advances



Source: Reserve Bank of India (2012)

Surely, one could rationalise these medium-term hurdles as the "new normal" of cyclical behaviour in a finance-driven economy. But, considering the scale and scope of the boom-and-bust cycle, it could hurt the credibility of the corporate sector, affecting business expectations for the foreseeable future. In a stock market-centric financial system, such economic downturns are perhaps quickly resolved by efficient bankruptcy procedures. But, in a bank-centric financial system like India's, with poor contract enforcement, legal wrangles could prolong – as is evident in the ongoing Kingfisher Airlines case – and hence institutional efforts to put the engine of private corporate investment back on the rails may take a while.

Figure 20: Banking Sector's Restructured Advances as a Per Cent of Gross Advances of SCBs



Source: Reserve Bank of India (2012).

6 Summary and Conclusions

The Indian economy boomed for five years at close to 9% annually, from 2003-04 to 2007-08. Output expansion was underpinned by a sharp rise in the investment rate, largely domestically-financed, boosted by an unprecedented influx of foreign private capital under benign macroeconomic conditions.

What triggered the boom? From the demand side, a sharp upturn in world trade since 2002, and the technological change in communications (a "revolution", in Alan Blinder's reckoning), combined with the deregulation of the financial sector in the US gave birth to the outsourcing industry, boosting India's services exports. It was surely an episode of export-led growth, with the export-to-GDP ratio going up by 9 percentage points in five years. The expansion of bank credit, topped by a flood of foreign private capital, enabled the expansion of aggregate supply. The financial crisis and the world economic slump took away the favourable conditions after 2008. However, growth after the crisis was mostly restored, by loosening the monetary policy and stepping up public expenditure, before it turned distinctively adverse by 2012-13.

The boom has two faces: the real sector, and its financial counter part. Prima facie, it was an exceptional phase of growth in the industrial and services sectors for five years. On a closer look, however, the expansion had many dark spots:
(i) A narrow base, with most of the incremental output coming from a few capital-intensive industries like automobiles and a few services like outsourcing and telecom.
(ii) Incremental investment was skewed in favour of capital- and skill-intensive registered manufacturing (especially, the automotive industry), with a marginal rise in infrastructure's

share, despite a sharp rise in domestic credit and abundant access to foreign capital.

(iii) The growth in power generation capacity improved during the boom, yet it was not adequate to reverse the long-term decline. Modernisation of the national highway network seems satisfactory, but the record of rural road construction (which is also part of Bharat Nirman) was abysmal during the boom, but improved somewhat afterwards.

(iv) By type of assets, share of construction in fixed investment declined, and its composition changed in some notable ways. Residential construction's share in the total declined (despite a sharp rise in housing mortgages), at the expense of non-residential construction.

(v) The financial crisis hit employment in labour-intensive manufacturing. Between 2004-05 and 2009-10, there was no employment growth, but a distinct decline in female labour force participation rates was discernible. However, wages went up across the board, though at rates lower than the rise in per capita income.

Despite a sharp rise in the domestic savings rate, it was a debt-led growth, financed by burgeoning bank credit to the private corporate sector, and boosted by a surge in foreign private capital in three principal streams, namely, FDI, FPI and FCCBs. FDI rose from 0.6% of GDP in 2003-04 to 2.8% of GDP in 2007-8; and, the total capital inflow (sum of FDI, FPI and ECBs) reached 10% of GDP just before the financial crisis struck in 2008. While the aggregate FDI inflow was enormous, only about 40% of it went into avenues that could, in principle, augment potential output. PE/VC/HF (the sources with shorter time horizons), and the round-tripped Indian capital that took advantage of tax-free returns, together constituted nearly 60% of the FDI inflows, contributing little by way of technology, or to the economy's long-term growth potential.

Disproportionately faster growth of credit and capital inflows, compared to the rate of fixed investment growth, especially in infrastructure, raised corporate leverage. The newer forms of FDI, with shorter time horizons, were invested heavily in newer, and often unlisted, enterprises, which sought to leverage such funds to make it to the big league quickly.

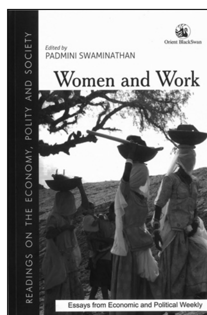
It is hypothesised that such funds have also found their way into asset markets, stoking the prices of stocks, land and property, which have remained stubbornly high, despite the economic slowdown and decline in corporate profitability after the financial crisis. With the decline in external markets, contraction of investment demand and adverse macroeconomic conditions, the corporate debt burden has turned onerous, swelling, in turn, the banking sector's non-performing assets, denting its profitability and restricting its lending potential.

If the foregoing reasoning and evidence are credible and weighty, then one perhaps needs to be cautious in signifying the boom as a new phase of growth acceleration. It was a debt-led boom leading to "rapid monetary expansion, inflationary pressures, real exchange rate appreciation and widening current account deficits", as Calvo et al (1996: 124) cautioned against the perils of capital inflows. The boom appears episodic, which is now gradually deflating, unless, of course, domestic output or export markets turn around dramatically.

Women and Work

Edited by

PADMINI SWAMINATHAN



The notion of 'work and employment' for women is complex. In India, fewer women participate in employment compared to men. While economic factors determine men's participation in employment, women's participation depends on diverse reasons and is often rooted in a complex interplay of economic, cultural, social and personal factors.

The introduction talks of the oppression faced by wage-earning women due to patriarchal norms and capitalist relations of production, while demonstrating how policies and programmes based on national income accounts and labour force surveys seriously disadvantage women.

This volume analyses the concept of 'work', the economic contribution of women, and the consequences of gendering of work, while focusing on women engaged in varied work in different parts of India, living and working in dismal conditions, and earning paltry incomes.

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If the corporate de-leveraging is deep and prolonged (as it seems to be the case), and the froth in the asset markets deflates only gradually, then their cumulative effect could erode the gains in output growth made during the boom. But, for now, the problem seems substantial enough to dent the financial performance of the corporate sector, and depress its investment prospects.

Therefore, the debate on policy paralysis and policy options, referred to in the introduction, needs to be seen in the light of the foregoing analysis. Since the incremental growth during the boom was largely driven by external demand, it may be quite a while before India can reclaim those markets, given the current state of the world economy and growing protectionism. (The "Buy America" provision of the recent US law is a case in point.) In other words, India needs to rework its "export model" to regain its external markets.

Fortunately, for now, policymakers seem unanimous on the need to focus on domestic growth that is largely restrained by a contraction in investment demand. This, in principle, can be addressed by stepping up public infrastructure investment following Keynesian principles, complemented by extending bank credit for productive investments in agriculture and unorganised or informal sectors. Sound macroeconomic evidence supports the "crowding-in" hypothesis, via demand and supply linkages (Pandit 1995). Such an effort would boost the confidence of not just foreign investors, but domestic stakeholders as well.

But the policymakers have expressed their unalloyed faith in fiscal orthodoxy and a commitment to easing the rules for foreign capital inflow, as is evident from the finance minister's recent reiteration of his commitment of a 3% fiscal deficit target, yet promising to step up investment demand. Foreign private capital can come into infrastructure only if it is assured of a 15-16% rate of return guaranteed against exchange rate risks, as amply demonstrated by the Enron debacle in Maharashtra. At such rates of return, most infrastructure investments are unlikely to be economically viable.

Offering more and more incentives to foreign capital in the current global uncertainty and the unprecedented external imbalance is a sure recipe for the nation to become hostage to short term, volatile capital that could exploit the situation to the hilt.[21] No amount of financial engineering can obscure the fact that infrastructure investments are capital-intensive with long gestation periods, and face uncertainty in pricing output, given their public goods character. If policymakers are looking to FDI as a tool to manage the current account deficit (as seems to be the case), which has crossed 6% of GDP in the most recent quarter, it is certainly a costly and risky game – especially with domestic political uncertainty looming large on the horizon.[22]

In hard times, prudence calls for living within one's means. The high world energy prices need to be passed on to domestic consumers to avoid external debt and its adverse effect on petroleum refiners. To avoid domestic infrastructure suppliers getting financially crippled and seeking fiscal help, they should be allowed to raise prices of public utilities to recover costs, and earn surplus for reinvestment. However, restricting public infrastructure investment, when the incremental public debt is held domestically in the local currency – after all, it is a debt to ourselves – is perhaps misplaced prudence, as the incremental fiscal deficit on account of such investment would be self-liquidating in the medium term, with rise in output and gains in public revenues.

Despite the worldwide chorus for reforming the architecture of the international financial system (as is evident from the recommendations of numerous national and international committees and commissions), little progress has been made on the ground as yet (Johnson 2012). So, the deep systemic flaws that caused the crisis very much remain with us. As is widely acknowledged, "shadow banking", which was at the root of the financial crisis, has now recovered its growth (which also contributed to the surge in inflow during the boom), standing at $67 trillion in 2011, up from $62 trillion in 2007 – accounting for 111% of GDP of the world's 27 major economic jurisdictions (Financial Stability Board 2012). So, it would be incautious to get carried away by the fortuitous exception in 2008, and, instead, be aware of the lurking dangers of surges in short-term capital inflows in search of higher yield. With the continued easy monetary conditions in the US, and now also in Japan, there is every likelihood of the recurrence of a fresh bout of capital outflows from the advanced countries.[23]

Therefore, large and poor countries like India need to strengthen their financial systems to tap global markets for long-term capital, without getting blown away by a flood of short-term capital inflows. Such a suggestion need not be perceived as an argument against international economic integration; what matters is the nature of the integration (strategic or unilateral) and whether it is consistent with long-term national interests.

NOTES

1 Unless otherwise mentioned, all growth rates reported in the paper are at constant prices.

2 IMF's *World Economic Outlook*, October 2012 has lowered the forecasts of world economic growth for 2013 from 3.9% to 3.6%.

3 As Lant Pritchett (2000) said: "A single time trend does not adequately characterize the evolution of GDP per capita in most developing countries. Instability in growth rates over time for a single country is great, relative to both the average level of growth and the variance across countries. These shifts in growth rates lead to distinct patterns. While some countries have steady growth (hills and steep hills), others have rapid growth followed by stagnation (plateaus), rapid growth followed by decline (mountains) or even catastrophic falls (cliffs), continuous stagnation (plains), or steady decline (valleys)... research into what initiates (or halts) episodes of growth has high potential" (p 221).

4 In 2011-12, the US accounted for 52% of India's IT and ITES exports.

5 For a discussion on the definitional issues that bedeviled the official FDI estimates, see Srivastava (2003).

6 The agricultural growth rate of 5.0% during the boom is deceptive because the growth rate in the base year was negative at 7.7%.

7 Services growth was perhaps overestimated due to methodological infirmities (Nagaraj 2009). However, this does not negate the fact that there was indeed a remarkable output boom.

8 The size and growth rate of the private corporate sector is perhaps overestimated because of methodological infirmities, as discussed in Nagaraj (2008). However, this is not to deny that the private corporate sector did witness substantial growth.

9 Since 2004, infrastructure investment was promoted under public-private partnership (PPP), with generous credit from the banking system, augmented by foreign capital inflows.

10 It is often a puzzle how the output boomed without adequate supply of electric power. The simple answer is that the services sector is not energy-intensive, unlike manufacturing.

11 Initiated in 2000, PMGSY targeted to connect 1,67,000 unconnected habitations with a population of 500 persons (or 250 persons in remote and hilly areas) by constructing 3,71,000 km of new roads, and upgrade 3,68,000 km of existing roads. In 2005, under *Bharat Nirman*, the targets were reduced to one-third: to connect 59,564 habitations of population of 1,000 persons (500 in remote and hilly areas) by constructing 1,46,185 km of new roads, and upgrading 1,94,130 km of existing rural roads. Progress was poor during the boom, but improved later: So far, 56% of the original targets of new road construction, and 37% of the upgradation of the existing roads have been completed. (http://omms.nic.in/Aspnet/Citizens/NAT/06NPW/SPWLocalization.aspx?lang=en&value=9ed2e74b5d2cc188faba67ac5010be64, accessed on 1 April 2013).

12 Liberal scholars would contend that rigid labour laws make it impossible for employers to use labour flexibly. But the substantial retrenchments in labour-intensive manufacturing in the organised sector, witnessed after the financial crisis, refutes such a simplistic understanding of labour laws.

13 As per the OECD definition, FDI is "a category of cross-border investment made by a resident entity in one economy (the direct investor) with the objective of establishing a *lasting interest in an enterprise* (the direct investment enterprise) that is resident in an economy other than that of the direct investor" (quoted in Rao and Dhar, pages 5-6).

Similarly, defining private equity being qualified as FDI is disputed by UNCTAD: "Cross-border investments of private equity funds that lead to an ownership of 10% or more are in most cases recorded as FDI *even if private equity funds do not always have the motivation for a lasting interest or a long-term relationship with the acquired enterprise* (quoted in Rao and Dhar 2011, page 9).

14 The court case in London against some Anil Ambani-owned or controlled companies, as reported in *The Financial Times,* also seems to point towards the same practice. *The Financial Times* reported on UBS and Anil Ambani: "UBS's 'mega-client' comes under scrutiny", *The Financial Times*, 16 December 2011. See also "Anil Ambani, an FII Investor?" by Vidya Ram in *Business Line*, 10 June 2012.

15 Perhaps it is not a coincidence that the urban land ceiling act was repealed in 1999, facilitating easy land acquisition (http://jnnurm.nic.in/wp-content/uploads/2011/01/Mandatory_Primer_5-RepealULCRA.pdf; accessed on 10 January 2013). Since it is a state act, it took a while for the repeal to make a tangible impact on the urban land market.

16 Though little hard evidence can be adduced, there is a widespread impression that agricultural land prices have shot up across the country (including in remote areas) since the mid-2000s. Land is being acquired not for cultivation, but for non-agricultural purposes. If true, one suspects, the repeal of urban land ceiling acts contributed to such socially unproductive investments.

17 Predatory lending "... [t]ypically involves imposing unfair and abusive loan terms on borrowers...Characteristics potentially associated with predatory lending include, but are not limited to, (1) abusive collection practices, (2) balloon payments with unrealistic repayment terms, (3) equity stripping associated with repeat refinancing and excessive fees, and (4) excessive interest rates that may involve steering a borrower to a higher-cost loan". (Office of Inspector General, *Challenges and FDIC Efforts Related to Predatory Lending*, Report No 06-011, June 2006 (http://www.fdicoig.gov/reports06/06-011.pdf), accessed on 7 January 2013).

18 Pay revision for government employees came handy to prop up consumption demand, as evident from Table 1, cols 5 and 6. It shows that GDP growth in "public administration and defense" (which is nothing but the salaries and pensions of government servants and defense personnel), grew at 13.1% between 2008-09 and 20010-11, compared to just 4.6% during the boom.

19 The recent boom seems similar to what happened during 1992-96, when the stock market boom led to real estate boom. For some evidence see Nagaraj (1997).

20 Suzlon Energy, the world's fifth-largest manufacturer of wind energy turbines, faces debt default, as it is unable to repay $220 million FCCB (*Business Standard*, 12 October 2012).

21 The Hindu *Business Line* (BL) reported: "The foreign investments into Indian markets through 'Participatory Notes', a preferred route for overseas HNIs and hedge funds, rose to a six-month high of Rs 1,46,600 crore (about $27 billion) in September, as various reform measures helped boost investor sentiments" (*BL*, 1 November 2012). As is widely known, "The P-Notes, mostly used by overseas HNIs (high net worth individuals), hedge funds and other foreign institutions, allow them to invest into Indian markets through already registered FIIs, while saving on time and costs associated with direct registrations."

Such short-term, probably round-tripped foreign capital is likely to flood India, which would only contribute to vulnerability, adding little by way of capital formation.

22 *Financial Times* recently observed: "These deficit figures imply the INR [Indian rupee] will remain acutely vulnerable to any slowing in the pace of hot money inflows" ("India's trade deficit: warning shot for currency and stocks", *The Financial Times*, 12 December 2012).

23 In its chapter on "The Limits of Monetary Policy", Bank of International Settlements' 82nd annual report (Basel, 24 June 2012), stated: "In the major advanced economies, policy rates remain very low and central bank balance sheets continue to expand in the wake of new rounds of balance sheet policy measures. These extraordinarily accommodative monetary conditions are being transmitted to emerging market economies in the form of undesirable exchange rate and capital flow volatility" (page 34), http://www.bis.org/publ/arpdf/ar2012e.pdf , accessed on 27 February 2013.

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