Economic Challenges to the New Government

A Policy Proposal

R NAGARAJ

India faces two distinct uncertainties in the short run: the nature of the electoral outcome, and the reduction in the United States' bond buying programme. The potential shocks could cause short-term volatility, though the economy now seems better placed than a year ago to face the challenge. Yet, stabilisation does not ensure economic revival. Stepping up investment demand, without jeopardising the current account balance and increasing external debt would be the key to sustainable growth. As the private corporate sector is mired in debt, a pragmatic increase in public investment by revisiting fiscal rules is the only credible option. A complete pass-through of fuel prices to domestic consumers would encourage investment in the industrial and energy sectors, while an easy credit for agriculture and small-scale industry is likely to augment wage goods output to restrain the rise in consumer prices.

R Nagaraj (*nag@igidr.ac.in*) is with the Indira Gandhi Institute of Development Research, Mumbai.

The Indian economy, as of April 2014, looks less vulnerable than it did a year ago. The current account deficit (CAD) that had peaked at 6.5% of GDP in the third quarter (October-December) of 2012-13 has declined to 0.9% of GDP a year later, in October-December 2013-14. Inflation, however measured, has moderated; external reserves have climbed back to over $300 billion, mainly with the increased inflow of non-resident Indian (NRI) deposits of two to three years maturity. India has secured a standby $50 billion line of credit from the Bank of Japan.

Yet, the new government will face two distinct economic challenges: one, the immediate external financial instability; two, reviving economic growth that has decelerated after 2010-11, recording the decade's low of 4.5% in 2012-13. Section 1 deals with the short-run considerations, and Section 2 with the medium-term concerns. Section 3 concludes by summarising the main findings and policy suggestions.

1 Securing Financial Stability

India is likely to have ended 2013-14 with a trade deficit of 10.5% of GDP (or $138.5 billion), and a CAD of 1.8% of GDP – financed by short-term foreign capital inflows (or, hot money in simple terms). Two threats loom large over these inflows posing a distinct possibility of a sudden reversal. One, a fractured political mandate in the general elections; two, a speeding up of the tapering of quantitative easing (QE) by the United States Federal Reserve which would raise world interest rates, and thereby reduce the margin between the risk-free US bonds and return on Indian investments. The tapering of the QE seems a certainty, but a sharp rise in global interest rates may not be inevitable, as the global economic prospects remain precarious. The International Monetary Fund's (IMF) *World Economic Outlook*, in its April 2014 edition, forecasts only a marginal (0.3%) improvement in economic prospects in 2015, over the projection of 3.6% for 2014.

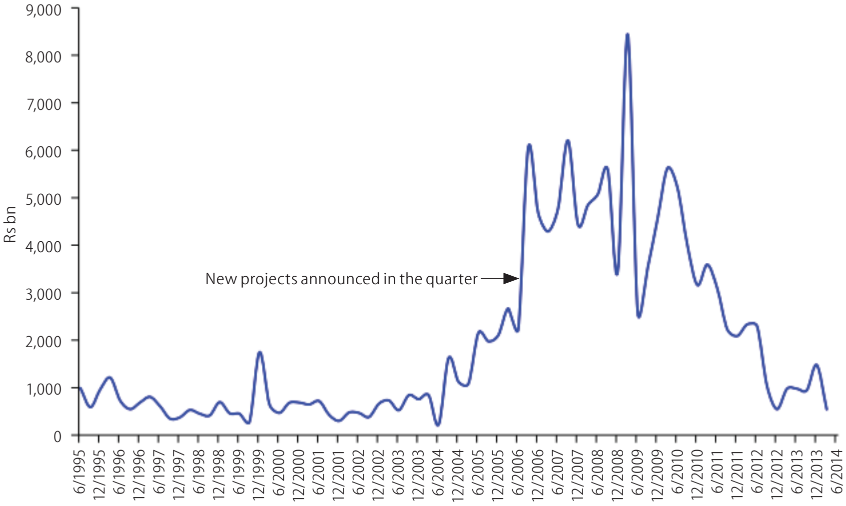
Consider the worst-case scenario: an unstable "anti-reform" coalition comes to power, raising the risk of capital outflow and high volatility in financial markets. If the new government seeks to "discipline" the markets, a "sudden stop" of the inflow cannot be ruled out, compelling the sovereign government to retrace such steps (however unacceptable they might be from the national point of view). But, as India has been a lucrative market compared to other emerging market economies (EMEs), foreign investors with a longer time horizon (like pension funds) are likely to stay put, ignoring the short-term uncertainties. In that case, as the post-election volatility recedes, markets are likely to get stabilised.

If, however, the electoral outcome favours a stable pro-business coalition (as many forecasters have predicted), short-term capital may flood India, sending the rupee and stock prices soaring, adversely affecting export earnings, posing a challenge to the central bank to mop up the inflows with minimum damage to the real sector. As the initial euphoria recedes, however, financial markets are likely to get stabilised over three to six months.

In either case, the economy is likely to be buffeted by the fickle sentiments of financial markets, and strategic behaviour of foreign investors, the costs of which to the real sector are difficult to anticipate, let alone measure. How ready is the economy to withstand such shocks? Apparently well, unlike the east Asian economies in 1997, India has a flexible exchange rate to absorb the shock and foreign exchange reserves serve as a cushion.

Yet, it will be difficult for India to lower its guard. As an abundant precaution, it may yet be prudent to negotiate lines of credit from the IMF (as some EMEs have apparently done), as an insurance against the potential threats of capital outflows. Such standby arrangements

Figure 1: New Project Announcements



Source: http/capex.cmie.com (Centre for Monitoring Indian Economy), Citi Research.

would also send positive signal about the economy's long-term prospects.

2 Economic Policy for the Medium Term

Assuming the economy manages to successfully ward off the short-term threats, what next? As Rudigar Dornsbush famously said, "stabilization may be inevitable, but it is not a ticket to prosperity… The risk that stagnation will follow stabilization is thus very grave" (Dornbusch 1993: 54). In our case it could mean a further deceleration of growth. What then should be the economic policy in the medium term?

The economy is, admittedly, in a poor state: recording less than half the growth rate it registered just a few years ago, with inflation above the tolerable level and a precarious balance of payments situation. How did the economy so quickly get into such a precipitous situation? A reasonable answer to the question, we believe, could help formulate suitable policies for the future.

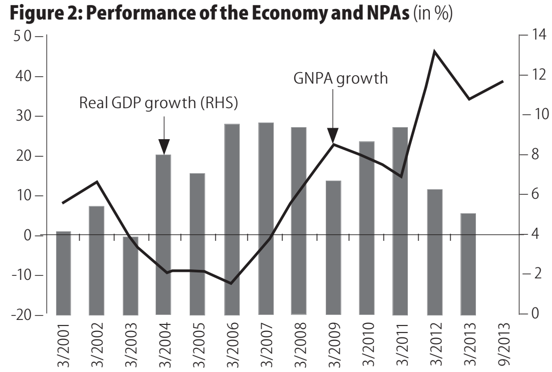
In popular and political discourse, "policy paralysis" in the last few years is responsible for the current mess, as evident from a sharp decline in investment projects approved after the financial crisis (Figure 1). This is largely attributed to the government's inability to sustain a business-friendly policy because of the regulatory failure and judicial overactivism, which is said to have scared away foreign investors, plummeting investment and output growth.[1] The implications of such a diagnosis are obvious: a stable pragmatic government is all that is needed to revive growth. We find the policy paralysis hypothesis too simplistic to be taken seriously. Perhaps, one needs to step back a little and analyse what happened during the economic cycle over the last decade to understand the current situation (Nagaraj 2013).

2.1 Understanding the Cycle of Economic Boom and Bust

For five years between 2003-04 and 2007-08, the economy boomed at close to 9% a year, before it was punctured by the global financial crisis. The surge in capital flows took place after the US Fed under Alan Greenspan eased monetary policy and world trade revived until the financial crisis struck in 2008.[2]

India's boom consisted of an export-led growth in IT outsourcing and capital-intensive manufactures, financed by a domestic saving rate that rose to over 35% of GDP (close to the east Asian level), topped up by an influx of foreign private capital. The private corporate sector (PCS) was the engine of the investment boom, as the public sector contracted (by design), and agriculture performed indifferently. The easing of rules for foreign direct investment (FDI) in real estate and in special economic zones (SEZs) created a virgin area for capital inflows to enter India, causing a steep rise in asset prices across the country. However, as the macroeconomic conditions – inflation, interest rate and balance of payments (BoP) – turned adverse after the financial crisis, the debt-led growth unravelled, with rising costs and a growing interest burden, declining revenues and profits, rising bank non-performing assets (NPAs), and decelerating investment growth (Table 1, Figure 2).

Figure 2: Performance of the Economy and NPAs (in %)



Source: Reproduced from Chart 2.18, RBI, *Financial Stability Report*, Issue No 8, December 2013.

Table 1: Macroeconomic Trends (2002-03 to 2012-13)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Annual GDP growth rate (%)	3.8	8.5	7.5	9.5	9.6	9.3	6.8	8	8.9	6.7	4.5
GDP deflator (%)	3.8	3.4	5.5	4.2	6.4	6.0	8.0	7.6	9.8	8.5	7.1
WPI – all commodities (%)	3.4	5.5	6.5	4.4	6.6	4.7	8.1	3.8	9.6	8.9	7.4
CPI-AL (%)	3.1	3.9	2.6	3.9	7.9	7.4	10.2	13.9	10.0	8.2	10.0
CAD (% GDP)	1.2	2.3	-0.4	-1.2	-1.0	-1.3	-2.3	-2.8	-2.6	-4.2	-4.8
Trade balance (% GDP)	-2.1	-2.3	-4.8	-6.4	-6.5	-7.4	-9.8	-8.6	-7.5	-10.2	-10.6
GDS rate (%GDPmp)	26.3	29.8	32.4	33.4	34.6	36.8	32.0	33.7	33.7	31.3	30.1
GCF (% of GDPmp at current prices)	25.0	26.1	32.5	34.3	35.9	38.0	35.5	36.3	36.5	36.4	34.7
GFCF (%GDPmp at constant prices)	24.4	25.0	28.7	30.5	31.8	33.7	33.5	33.3	33.5	35.3	33.9
Private corporate fixed investment (% GDP)	6.4	7.3	10.0	13.0	14.0	16.0	12.0	12.0	13.0	12.2	11.2
International oil prices (in $ per barrel)	31.1	41.4	56.5	66.0	72.3	99.6	61.7	79.4	94.9	94.1	97.9

Sources: *National Accounts Statistics*, various issues; RBI's *Handbook of Statistics on Indian Economy*; Reuters.

A concerted move by the world's major economies loosened monetary and fiscal policies to sustain domestic demand to compensate for the collapse of world demand, preventing the world from getting into a depression. After the panic passed, the developed world remained mired in the Great Recession, so the US initiated the historically unprecedented bond purchase programme – the QE. Capital inflows to the emerging markets then resumed in search of a higher return (or yield). India managed to get over the financial crisis to sustain the high growth for the next two years (until 2010-11), but the economy faltered thereafter with heightened macroeconomic instability.

In short, with the collapse of external demand, capital investment in manufacturing and infrastructure declined and economic growth then stalled, while food inflation remained high for lack of adequate investment in food and consumer goods industries. Yet, with declining export revenues, the rising cost of servicing external debt (in various forms) and continued liberal imports of gold, the CAD peaked to an unprecedented level, close to 5% of GDP in 2012-13.

If the foregoing explanation of a cyclical boom and bust is credible, reviving growth would call for a different set of policies than what would follow from the hypothesis of "policy paralysis". Based on our analysis, the crux of the solution would be to step up investment demand to the levels attained during the last decade, *but* within the tolerable limits of CAD and external debt. Before outlining such a strategy, it seems necessary to discuss ways to insulate the external balance from the negative fallout of the current global economic situation.

2.2 Correcting the External Imbalance

In the last decade, while India's trade openness (imports plus exports as a proportion of GDP) more than doubled, its openness to foreign private capital multiplied manifold. Though external debt has remained a modest fraction of GDP, its composition has changed for the worse. Until the early 2000s or so, India's CAD was mostly financed by official sources of aid and loans – that is, multilateral and bilateral sources – with a large share of it at concessional interest rates (Table 2). NRI deposits were the principal source of private capital flows which have remained largely stable and mostly a non-repatriable source of finance based on the earnings of Indians working abroad.

Table 2: India's External Debt

Year	Debt Stock – GDP Ratio	Debt Service Ratio (%)	Short-term Debt as % of Total Debt	Concessional Debt as % of Total Debt
1991	28.7	35.3	10.2	45.9
2001	22.5	16.6	3.6	35.4
2013	21.2	5.9	24.8	11.7

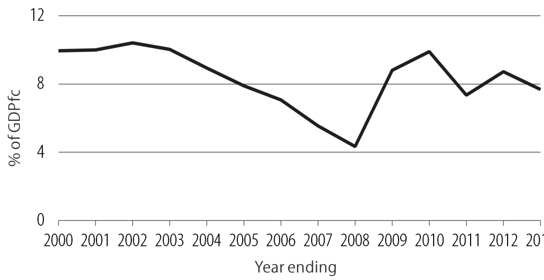
Source: RBI's *Handbook of Statistics on Indian Economy.*

The openness to private capital inflows increased in the last decade as the official sources dried up. Moreover, as part of financial liberalisation, foreign capital (in all forms) was generously welcomed to invest in all but a few industries. Even non-traded goods sectors such as construction, infrastructure and real estate were opened to foreign capital. At its peak, in 2007-08, when the CAD was a mere 2.5% of GDP, capital inflows as a proportion of GDP amounted to 10% of GDP, thus leading to an accumulation of foreign reserves – a widely applauded outcome of liberal policies.

The external debt was mostly incurred by large private corporate firms, as the public sector's share in it declined. As a result, as of December 2013, the private sector's share in total external debt went up to 82% (http://finmin.nic.in/the_ministry/dept_eco_affairs/economic_div/External_Debt_QDEC2013.pdf). In fact, public infrastructure investment was shrunk to reduce the fiscal deficit (Figure 3). Further, private firms were permitted to tap external commercial borrowings (ECBs) for domestic investment including infrastructure, though most of which were not expected to directly earn foreign exchange. This led to a currency mismatch (by design). Many large projects were also allowed to import substantial capital equipment using suppliers' credit (which is essentially short-term credit). Such a policy mix was probably justifiable in a booming economy and a rising export-GDP ratio, but it grossly ignored the downside risk – which hit the economy after 2010-11.

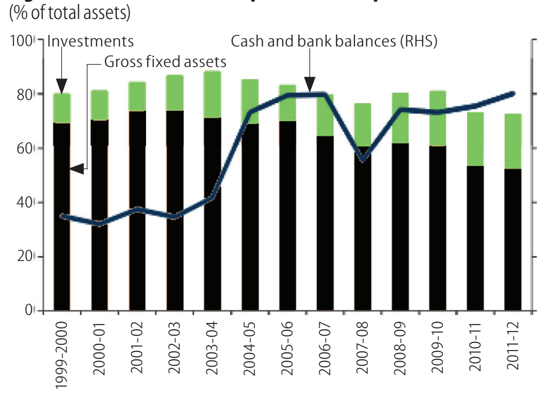
For the following reason the true magnitude of the PCS's external debt is probably far more than what is evident in the official debt statistics. Overseas subsidiaries of large firms have raised a substantial amount of debt guaranteed by their Indian parent firms. These funds are used not only to finance domestic investment, but also for acquiring factories and firms internationally – what gets counted as India's outward FDI. Insofar as such acquisitions generate dollar revenue to repay dollar-denominated debt, they may not become a burden on their parent entities. But there is no way of knowing the factual position. A sizeable fraction of such loans is reportedly brought into India to earn higher domestic interest rate (arbitrage), which shows up in rising cash holdings and investments of the PCS (Figure 4).

Figure 3: Fiscal Deficit



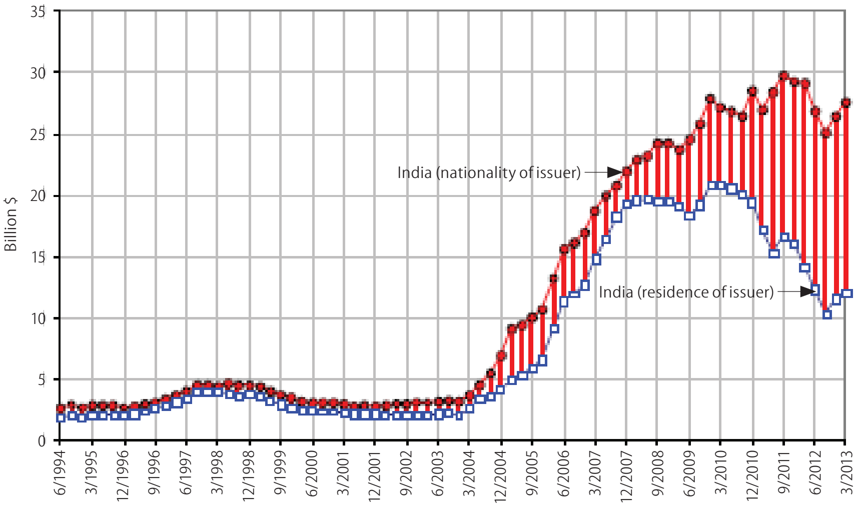
Source: *Handbook of Statistics on Indian Economy*, RBI website.

Figure 4: Trends in Asset Composition of Corporate Sector
(% of total assets)



Source: Reproduced from Chart 1.21, RBI, *Financial Stability Report*, Issue No 8, December 2013.

Figure 5: International Debt Securities Outstanding for Non-financial Corporates by Nationality and by Residence



Source: Reproduced from Shin (2013).

Such loans raised by Indian subsidiaries abroad remain hidden from the official debt statistics since the data are collected according to the "residence of the issuer", not according to the "nationality of the issuer". A recent effort at reconciling these debt estimates using Bank of International Settlement (BIS) data are quite revealing: as of March 2013, the international debt of non-financial Indian corporate firms more than doubled – from about $12 billion to about $28 billion (Figure 5).[3] As Hyun Song Shin (2013) observed,

> [the] Indian corporate which borrows in US dollars through its London subsidiary and which defrays the group's costs using the dollars, but which then accumulates Rupees instead at headquarters. The Rupees are then held as time deposits in a local bank in India. In both instances, the firm has engineered a currency mismatch. In effect, the firm has taken on a carry trade position, holding cash in local currency financed with dollar liabilities (p 5).

While the additional debt does not seem alarming (compared to China and Brazil), the costs of servicing could go up with the rise in global interest rates, accentuating India's vulnerability to the tapering of the QE. This is perhaps the reason why report of Credit Suisse (dated March 2014) claims that most of the debts of infrastructure loans remain as hidden NPAs that can potentially affect the banking sector.[4] The rating agency Fitch has said that the NPAs and restructured loans together could rise to 15% of all loans for the banking sector by the end of 2014-15 (*Business Standard*, 18 April 2014).

If the foregoing arguments merit attention, then they portend a prolonged period of costly debt servicing and restructuring, adversely affecting bank lending for private corporate investment. In view of these seemingly costly misadventures of external financing with a currency mismatch, the PCS's external financing rules need to be thought a new. Perhaps there is a case for reducing reliance on short-term credit and project finance.

Realistically assessing the last decade's boom, the after-effects of the debt-led growth seem to now extract high costs from the economy. The external openness seems to have increased the effective costs of doing business for domestic firms. The increased vulnerability to exchange rate volatility and the stock market gyrations seem to have taken entrepreneurial attention and energy away from capital investment-output-innovation to short-term treasury management and stock market operations, affecting productivity growth. If our characterisation is correct, then there is a need to bring back capital controls gradually (without destabilising the markets) to give greater policy autonomy to domestic decision-makers (both in the public and private sectors) to enable them think long term (that is, investment, technical progress, etc) and give a greater autonomy to policymakers to steer the economy towards steady growth. To quote Stiglitz (2014), from a recent lecture delivered at the Federal Reserve Bank of Atlanta:

> When countries do not impose capital controls and allow exchange rates to vary freely, this can give rise to high levels of exchange rate volatility. The consequence can be high levels of economic volatility, imposing great costs on workers and firms throughout the economy. Even if they can lay off some of the risk, there is a cost to doing so. The very existence of this volatility affects the structure of the economy and overall economic performance.

Moreover, capital controls are no longer heretical as they once were, considering the guarded approval they have received even from the IMF (Bluedorn et al 2013).

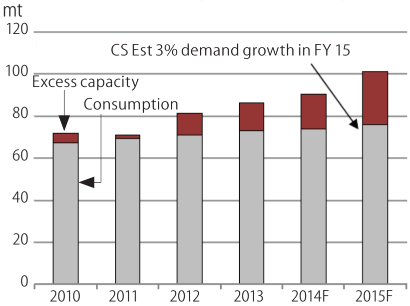
2.3 Reviving Investment Demand

If the explanation offered earlier for the boom and bust cycle is valid, then it seems naive to expect the economy to get back to an export-led high growth phase on the same basis any time soon. Sure, the US economy is showing signs of improvement, but China is sending out negative signals. So the overall assessment remains pessimistic. It would therefore be prudent to look for sources of growth in the domestic economy.

A steady rise in the trade deficit in the last 10 years (even ignoring the peak before the financial crisis) is a clear indication of the growing import dependence. Bring it down to a manageable level in the medium term would offer considerable scope for investment in manufacturing, and energy sectors. As the economy's infrastructure shortages are legendary, there is no need to belabour the requirement for such investments.

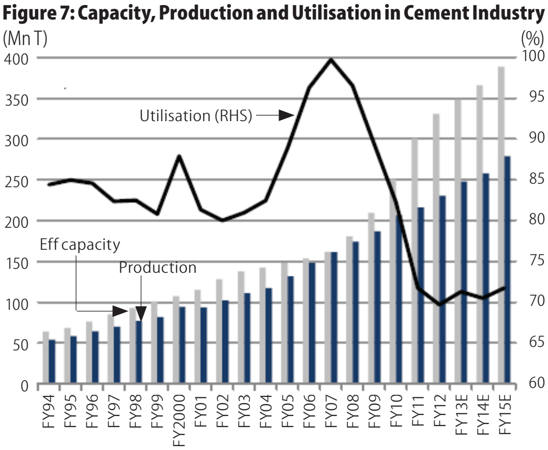
The Twelfth Plan document offers a useful blueprint for investments in infrastructure and energy, which can be followed up. Most of these proposals are yet to get translated into investments. Since there now exists considerable excess capacity in critical investment goods like steel and cement, boosting infrastructure could yield returns quickly (Figures 6 and 7, p 39). Moreover, such investments could "crowd-in" complementary private investment – the way the road-building programme initiated under the Golden Quadrilateral project in 2000 probably gave a fillip for the automotive industry. This time around one can envision investment in railway modernisation to play a similar role for the domestic rolling stock manufacturing industries. Industrial infrastructure perhaps needs to be location specific to support those activities with immense output and employment potential, activities such as textiles which, with rising real wages in China, seem to offer an immediate opportunity for India.

Figure 6: Excess Capacity in Steel Industry



Source: Reproduced from Figure 59, "Indian Market Strategy" by Credit Suisse, 19 March 2014.

Figure 7: Capacity, Production and Utilisation in Cement Industry



Source: Reproduced from Figure 60, "Indian Market Strategy" by Credit Suisse, 19 March 2014.

During the last decade, in the euphoria of services-led growth and burgeoning foreign exchange reserves (though made up of debt), manufactured imports were liberalised as the quickest route to improve competitiveness and augment exports. On top of it, numerous bilateral investment treaties (especially the one with Thailand) seem to have hastened import penetration allowing practically duty-free imports of a wide range of manufactures. Admittedly, while some of these factors could have improved export performance, the overvalued exchange rate during 2003-08 probably blunted the competitive edge (Figure 8).

After the financial crisis, while export growth plummeted, import growth continued apace, hurting the domestic industry.[5] This substantiates the arguments and evidence put together by Dhar et al 2012. The net result has been a sharp rise in the share of direct imports in total consumption (Chaudhuri 2013). Now under the changed growth prospects after the crisis, there is a dire need for rediscovering the value of domestic industrialisation, as the sine qua non for restoring external balance.

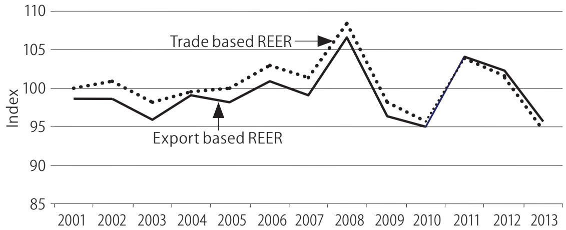
The foregoing arguments for reindustrialisation often do not find favour with policymakers on the ground that (i) infrastructure shortages are a binding constraint, and (ii) the alleged labour market rigidities preclude the setting up of large-scale manufacturing plants. Such views overlook the fact that some of the largest manufacturing plants, such as bicycles, are in India.

The former view is widely admitted but the latter is an extremely contested position. But there is little to believe that these constraints have worsened over the last decade so as to be pessimistic about revitalising manufacturing industries. If anything, infrastructure, with all the known shortcomings has improved in roads, ports and air transport. Labour unions have been on the back foot as the strength of organised labour has declined (other than in a few selected pockets). So there seems to be little reason to believe that a "a big push" to reindustrialisation cannot be initiated to meet the goals laid down in the National Manufacturing Policy (2011) for raising manufacturing GDP's share in the total to 25% by 2025. Until now the objective has remained a pious intention, without adequate instruments to translate it into reality (Mani 2011). If the new government overcomes these hurdles with a clear vision, there could be a lot to look forward to in the industrial sector.

2.4 Financing of Investment

As noted earlier, public investment shrunk during the boom to bring down the fiscal deficit, while the task of infrastructure investment was passed on to the private corporate sector (as part of the liberalisation policy), by allowing it (i) easy domestic credit (with a liberal debt-equity ratio), (ii) to tap foreign capital (equity, FII inflow into primary capital market, and ECBs) to make such capital-intensive industries attractive for private and foreign investment, as also for investment in some cases such as roads, and (iii) to levy user charges and realise commercial gains from real estate.

Figure 8: India's Real Exchange Rate (2001-13)



Source: *Handbook of Statistics on Indian Economy*, RBI website.

But the majority of these investments are yet to fructify for a variety of technical, regulatory and legal reasons. Since the debt servicing costs have shot up under changed circumstances – rising interest rates, currency depreciation, and slower output and export growth – many of these large loans have turned sticky, affecting financial returns. This, in turn, has led to rising NPAs of banks and growing implicit subsidies for these firms under corporate debt restructuring (CDR) by commercial banks.

Unless these loans are restructured now with implicit subsidies – in effect, by socialising the risks – there is little hope of them making profits. As the restructuring may take a while, there seems little likelihood of resumption of large-scale bank credit for the PCs. Foreign investors who rushed to make quick gains are now apparently fighting shy of making further investments.

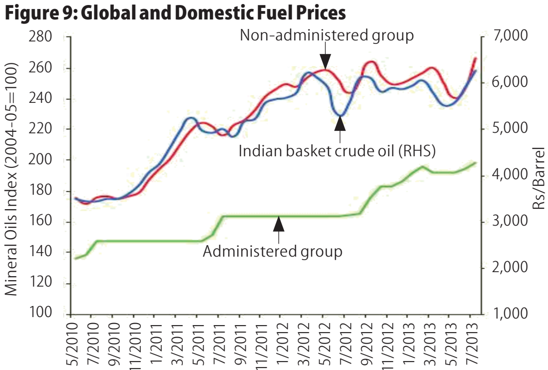
As the investment slowdown has a huge social cost in terms of foregone output and employment, it would be an eminently pragmatic move to step up public infrastructure investment – a view that even the IMF has recently been advocating. But such an option expectedly comes up against policymakers' commitment to fiscal orthodoxy – as also the red flag from the rating agencies with a threat of a rating downgrade. What is the way out?

2.5 Revisiting Fiscal Constraints

There is perhaps an urgent need to revisit fiscal constraints to modify the rules to permit larger public borrowing for capital investment, allowing states to tweak the Fiscal Responsibility Budget Management Act to make greater investment in state electricity boards and road transport corporations with suitable incentives for rational pricing and financial restructuring.

However, there is a case for fully allowing a pass through of international oil prices to domestic consumers to correct the fiscal and external imbalances, as the domestic prices are significantly lower than the world prices (Figure 9). It would encourage a more rational use of imported energy and induce energy saving investments.

Figure 9: Global and Domestic Fuel Prices



Source: Reproduced from Chart II.22, RBI Annual Report 2013.

If rising debt is denominated in domestic currency and is held by domestic residents and institutions, then the fiscal burden gets reduced to a question of how effectively the debt is used to augment domestic output and income and avoid inflationary pressure. One can do no better than quote Evsey Domar (1957: 64) to justify foregoing analytical position:

> If all the people and organisations who work and study, write articles and make speeches, worry and spend sleepless nights – all for the fear of debt – could forget about it for a while and spend even half of their efforts trying to find way of achieving a growing national income, their contribution to the benefit and welfare of humanity – and to the solutions of the debt problem – would be far greater.

The rating agencies' warnings are likely to have little impact on domestic investment if it is mostly financed domestically. External commercial borrowing will need to be restricted to investments that will directly pay for themselves in foreign exchange (to avoid the currency mismatch). Moreover, sustained higher growth based on domestic demand is likely to mute such external criticisms of national investment policy. Domestic debt-financed investment can fuel inflationary pressure, and could raise the CAD if the import content of the investment is high. Insofar as excess capacities exist in the industrial sector and ample food stocks are available, the potential imbalances of stepping up investment would be minimal.

However, there seems to be merit in increasing bank credit for agriculture and small-scale industry to augment the supply of food and consumer goods to relieve supply constraints of wage goods, the sectors that were starved of institutional credit in the last decade as part of financial sector reforms. There is perhaps also a need to restore the integrity to priority sector lending by strictly ensuring that these loans are made for productive purposes (Ramkumar and Chavan 2007). The potential costs of poor repayment are probably modest compared to the impending socialisation of the huge losses that the banking sector will incur on account of NPAs and CDR for the corporate sector.

3 Conclusions

India is currently faced with two kinds of risks in the short run: the election outcome and the possible rise in global interest rates with the reduction in the US Fed's bond purchase programme (the tapering of QE). In response, foreign investors (on whom we now depend to pay for a sizeable share of imports) may revise their bets on India. However, the economy now seems better placed than a year ago to face the impending volatility with a distinctly lower CAD, declining inflation and rebuilding of the currency reserves (mainly with enhanced NRI deposits). Assuming optimistically that economy withers the shocks, it is no guarantee that economic growth will naturally follow. So, what should be done to move from stabilisation to growth?

What we are now witnessing are the after-effects of the boom and bust cycle that the economy went through during the last decade. Export-led growth in services and capital-intensive manufactures collapsed with the financial crisis; investment growth declined with a lag after 2010-11, with the tightening of macroeconomic conditions and the decline in cheap capital inflows.

The economy is, therefore, currently suffering from reduced investment demand and high external and financial vulnerability. So any strategy for economic revival has to focus on boosting investment demand catering to the domestic market.

The private corporate sector is mired in deep debt, which is likely to take some time to unwind. It would therefore be pragmatic in the medium term to step up public infrastructure investment to stimulate investment demand, but this has to increasingly come from domestic finance, to minimise the vulnerability to the vagaries of foreign capital flows. For this to happen, fiscal rules need to be reworked to finance a larger public investment by public borrowing. Domestic credit needs to be extended to agriculture and small enterprises to augment the supply of food and consumer goods.

To put external balance on a sustainable path, there is a need to draw up a manufacturing and energy policy to reduce import dependence, which has grown substantially during the last boom and bust cycle (sustained under the euphoria of services-led growth and cheap foreign capital). In other words, the New Manufacturing Policy aimed at raising the share of manufacturing to 25% of GDP by 2015 needs to be implemented with all seriousness to place the economy on an externally sustainable domestic market-led growth path.

NOTES

1 Such a characterisation ignores the effect of the global financial crisis and the Great Recession that brought the world economy to a standstill. Closer home, the damage done by "crony capitalism" to long-term economic prospects needs to be borne in mind. If judicial activism hurt investment climate causing policy paralysis, it only reveals the rot in governance, exposed by social activism taking advantage of the Right to Information Act, 2005. See *The Economist* – the torchbearer of liberal capitalism – for a critical account of the nature of the recent accumulation process in India. It said, "scandals have rocked Asia's third-largest economy in the past decade. A lot of transactions

that put public resources into private hands – allocations of radio spectrum, for example, and of credit from state banks – have come under suspicion. Of the 10 biggest family firms by sales, seven have faced controversies. The brash new tycoons who came of age during the boom years of 2003-10 are under a cloud, too" (*The Economist*, 15 March 2015).

2 For an economic historian, the unfolding of the cycle would seem all too familiar. Writing nearly a century ago, Taussig said in 1928: "The loans from creditor countries … begin with a modest amount, then increase and proceed crescendo. They are like to be made in exceptionally large amounts towards the culminating stage of a period of activity and speculative upswing, and during that stage become large from month to month so long as the upswing continues. With the advent of crisis, are at once drawn down sharply, even cease entirely" (Taussig 1928) [as quoted in Dornbusch 1993].

3 This is true not just of India, but of many EMEs including China, Brazil and many Latin American economies. See Shin and Zhao (2013) and Powell (2014).

4 "[t]he major problems facing the banking system, i e, the prospect of sustained low loan growth for several years, as well as the still pending recognition of bad loans, are likely to persist for several years. CS … team has been highlighting that there is Rs 8.6 tn of loans with the top 200 companies with interest cover less than one. Only about 23% or Rs 2 tn has become NPA yet" (Credit Suisse: "India Market Strategy", 19 March 2014). While we have no means of verifying these claims, they so suggest the gravity of the problem as perceived by an investment advisor – a view consistent with the analysis reported above.

5 "Industry has been ruined by FTAs" says Baba Kalyani, Chairman of Bharat Forge, and Kalyani group of companies with a turnover of $2.5 billion, specialising in automotive forging, supplying to major OE manufacturers worldwide said recently in an interview, "Industry has been ruined by FTAs… because of the FTA, due to which companies come and set up plants here, they don't manufacture anything, they just assemble" (*The Hindu Business Line*, 10 February 2014).

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