ABHINAV
International Monthly Refereed Journal of Research In Management & Technology
ISSN – 2320-0073 Volume II, July'13

INDIAN ECONOMY: AN EMERGING ECONOMIC PARADIGM AMIDST GLOBAL CRISIS

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ABSTRACT

Abraham Lincoln, America's erstwhile President had eminently stated in one of his speeches: ***"****You cannot keep out of trouble by spending more than you earn". It must have been relatively unbelievable for US - the world's super power economy find itself eating its own former President's words many decades after.*

The US economy accounts for a propos a third of world output duly dragging the world economic growth alongside. All the same, the US today stands overleveraged. According to forecasts from the Organization for Economic Co-operation and Development in May, the US will have a budget deficit in excess of 10% of GDP this year, and a national debt of 101.1% of GDP. The US is not the only economy facing a crisis situation today. The world as such seems snowed under a triple crisis.

Given this milieu, this paper endeavors to determine more about the crisis, the deep-seated cause for the existing global tight spot and the opportunity thrown open to the Indian economy in the backdrop of the same.

INTRODUCTION

The US Debt crisis:

The US government is acutely in debt – more than 14.5 trillion dollars – and it borrows to meet its debt obligations every month. The debt is fundamentally the summation of all outstanding debt owed by the Federal Government. Nearly two-thirds of the debt is public debt, and the rest is owed by the government to itself, and is held as Government Account securities. Most of this is owed to Social Security (promises to baby boomers who may retire over the next 20 years). Between 2000 and 2007, the US debt grew 50% distending from \$6-\$9 trillion. The \$700 billion bailout helped the debt grow to \$10.5 trillion by December 2008. The debt level which is the debt as a percent of the total country's production, or GDP, which was \$14.7 trillion in 2010

There are more often than not more than adequate people agreeable to lend the US government money because it is seen as a very sheltered investment. But what wasn't quite customary for the US is that for the first time a sizeable number of Republican lawmakers were not prepared to consent to the additional borrowing unless colossal spending cuts without tax enlargements were agreed upon thanks to their debt ceiling model. US's Office of Management and Budget showed that in 2011 budget deficit was at \$1.3 trillion, more than the \$1.17 trillion deficit for 2010, but down from the \$1.7 trillion deficit for 2009. This was a result of the economic stimulus package, the 2008

government bailout measures and ~ $800 billion a year defense/security spending undertaken. The deficit is also supposed to have been caused by reduced income from the recession, as well as the EGTRRA and JGTRRA tax cuts and the Alternative Minimum Tax patch. US sovereign credit rating faced its first ever rating downgrade on 5 August when S&P downgraded its rating from AAA to AA+ with a negative outlook terming US's efforts to embark upon the debt levels as insufficient. World over there are now 18 countries which enjoy the AAA rating. US has enjoyed a AAA rating ever since rating agencies began assigning sovereign credit ratings to countries. Therefore S&P's decision scratched US's self-esteem and buoyancy. The only succor is that other leading agencies such as Moody's and Fitch continue their AAA rating for the US.

The meat in the rating downgrade plot is that it put the world's super power economy in a discomfited soup. Nevertheless the impact this kind of downgrade would have on the US is much lesser than the impact US's own conduct would have on its economy. US's predicament is that it has long since been spending over and above what it has been earning. In the past, we have seen that US capitalism sequestered surpluses and accrued capital. When this process went too far, in the late 19th century and early 20th centuries it concluded in the Wall Street collapse of the 1930s after which the government stepped in with strapping guidelines, anti-trust action and the welfare state.

Cutting to contemporary times US today faces problems of an imperial over-reach, and untenable welfare costs predominantly in healthcare. Although the wars of Iraq and Afghanistan put up costs of over $3 trillion the US budget deficits have chiefly been driven by an sumptuous medical care system. Clearly, the price of money is too low in the US and the country is spending too much.

Over the next 20 years, the Social Security funds must be paid back as the Baby Boomers retire. Since this money has been spent, resources need to be recognized to reimburse this loan. That would mean elevated taxes, since the high U.S. debt rules out further loans from other countries. Unfortunately, it's most likely that these benefits will be truncated, either to retirees younger than 70, or to those who are high income and as a result notionally don't require Social Security. Second, many of the foreign holders of U.S. debt are investing more in their own economies. Over time, emaciated demand for U.S. Treasuries could amplify interest rates, thus slowing the economy. in addition, anticipation of this lower demand puts descending pressure on the dollar. Federal debt therefore is like driving with an emergency brake on and will further slowdown the U.S. economy.

US's living beyond its means way of life has over the years been built on the postulation that dollar debts can be paid off by printing more of green stuff everlastingly. But the world seems to have been aware of US's secret because data between 2001 and now indicates that the world's holding of dollars as a part of forex has dropped by 12% (from 73% to 61% now). Also as the debt deal showed, US over the last three years is more at variance as a nation than it was ever before. Debt forgiveness more than monetary easing is perhaps an answer for the US. Nevertheless US is still the world's largest economy and therefore remains a good credit risk. Even after a downgrade, the government will likely still be able to pay its bills for years to come.

The EU Crisis:

The Euro zone officially euro area came into being in 1999. Euro is the official currency of the EU and the monetary policies of the zone is the responsibility of the European Central

Bank, though there is no common representation, governance or fiscal policy for the currency union. EU's setback started with Greece. Greece has been living beyond its resources in recent years, and its mounting level of debt has placed an enormous level of strain on the country's economy. The Greek government borrowed greatly and went on something of a spending extravaganza during the past decade. Public spending ascended and public sector wages virtually was twofold during that time. However, as the money gushed out of the government's treasury, tax income was hit because of widespread tax elusion. When the global financial downturn hit, Greece was ill-prepared to muddle through. Greece's budget deficit has been running tall with its public spending going over and above its revenues. In 2009 Greece's budget deficit came in at 13.6% of the GDP, one of the utmost levels in the Euro area and over four times the Eurozone eligibility limit. EU's problem became public with the Greek debt crisis which was among the highest. Everyone in the eurozone - and anyone who traded with the eurozone was affected by the Greece crisis because of the impact on the common European currency. The most instantaneous impact was on the 15 other eurozone economies who had approved to help out Greece. So taxpayers of these countries were to in point of fact share a component of Greece's encumber.

Greece's plight contained the trigger for a domino effect and deposed other frail members of the eurozone. Given that Greece, Portugal, Ireland and Spain are members of the PIGS, their infirmities were bound to affect economies of other countries of the EU sooner or later ensuing in an overall recession scenario for the EU. One can scrutinize a rise of yields on sovereign bonds in Europe's fringe economies (the PIIGS – Portugal, Ireland, Italy, Greece and Spain) which essentially designates that these countries are overleveraged and should fell their public debts.

Also EU has a structural quandary to handle. It has labour stringency, and very high tax rates which hold back investment and the conception of new-fangled jobs. If you look at the data, in the core EU of 16 countries, the tax-GDP ratio, which measures the overall tax burden as a fraction of GDP, is as high as 40 % (India's is currently less than a third of that), with top personal tax rates going as high as 56% in Sweden. The tax rates are more to finance the cradle to grave welfare policies. But this results in towering unemployment rates.

Infact both Europe and US are at unemployment rates of 9 – 10%. In Germany unemployment rates are at 7% while in some other EU areas like Spain, Greece etc the rates are as high as 21% and 16% respectively. This reveals that there is not adequate innovation or up gradation of skills to soak up labour at superior cost or that there is not sufficient candidness to import labour at costs that are feasible for manufacturing and services or that wages are too sticky on the downside. Besides there is a huge discrepancy in the unemployment rates within EU, which shows a lack of labour mobility intra EU.

What is right for the US is in certain ways is right for the EU as well. Unless Germany concurs to write of a part of the debt owed by PIIGS, there is scarcely a chance of resurgence. To add to EU's anguish, some of its economies like Germany, Spain, France etc should be going in for elections in the near term akin to the US which anticipates elections.

The humpty dumpty's of the world or the worlds three principal super power economies are facing catastrophic circumstances today – the US, the European Union and Japan. Therefore all is not really well with global capitalism. Or at least the part of the capitalist world that is also egalitarian. In Europe, a more socialist set up has been perceived however given that

there is larger recognition of higher taxes and state intrusion in economic activity. But socialism like capitalism is also a double rimmed sword is what the EU model has proven. This is because as data has revealed, too much overpriced welfare has been enforced by the gratuitous EU expansion policy without putting much fiscal groundwork to it connoting that EU's Peter will have to bail out EU's Paul if EU has to be kept together.

EU's tribulations are quite subterranean given that EU was created as a monetary union of European countries without an analogous fiscal union. This has turned out to be untenable. One substitute is for the relatively fragile countries of southern Europe to thrust aside the euro and recoup their flexibility over their individual currencies. The subsequent option is for Eurozone countries to go for some sort of fiscal amalgamation, in which the stronger countries pledge the debts of the weaker economies. But politicians have been finding both alternatives too far-reaching to contemplate, and seem to be choosing one fudge after another.

Post US's downgrade, global investors exited emerging markets and rushed into dollars as a secure haven. That underscores the fact that no matter how gigantic the troubles of the US may be, no other country looks a safer haven. Investors may desire for an alternative to the American dollar as the foremost global currency, but neither the euro nor yen look tenuously competent of taking its place. Although this is a theme of great delight for the US, it bowls major qualms on how the US is going to protract its place in the global economy.

US has amplified health costs than any other advanced economy and stumpy taxes by international standards. Nevertheless, the US remains unrivalled in its innovation and academic potency. A major plus for the US is that it is more undisturbed over immigration and has flexible labour laws. This should make its capitalist approach healthier and profitable. Also around the world people are looking for safe and liquid investment destinations and US's debt fits this bill more than anyone else. Although it seems to be slowing down, it is essential to scrutinize where exactly US's growth would stem from in the future. The contradiction arises because of the political debates taking place in the US where high-priced and exorbitant Medicare and social security programmes which hardly entail cost cutting procedures are being deliberated upon.

Focusing on Japan , the economy has been distressed for a couple of decades with its atypical Keynesianism model. Japan has the worst balance sheet of the major countries, with debt at 200 % of GDP, slow growth and a swiftly aging populace. In fact in this case Japan's problem bears a resemblance to that of EU – ageing population which immigration alone can perchance embark upon. Japan's share in Asia's exports has been on an unyielding decline from 12.5% in 1995 to 7.3% in 2010. Post the earthquake it witnessed in the recent past, the cost of restoration for Japan works out to US$ 300 bn which is a drawn-out task to fund for Japan given its massive debt. Japan is the second main buyer of US Funds and since it will require money to fund its restoration, it might either cash in on the US bonds persuading US FeD to buy these bonds which will kindle a liquidity crunch in the US market or the other way out is to pull out of the huge investments it has made across the capital markets.

India: The Emerging Economic Paradigm

After liberalisation, India's economy has boomed and slowed – in turn. In the first five years post reforms, the economy boomed. Then it slowed – all the way till 2003, excluding the dot com blip phase. Then it picked up steam but is not losing steam again. The United States is one of India's largest direct investors. From 1991 to 2004, the stock of FDI inflow has

increased from USD $11.3 million to $344.4 million, totaling $4.13 billion. This is a compound rate increase of 57.5% annually. Indian direct investments abroad were started in 1992. Indian corporations and registered partnership firms are allowed to invest in businesses up to 100% of their net worth. India's largest outgoing investments are manufacturing, which account for 54.8% of the country's foreign investments. The second largest are non-financial services (software development), which accounts for 35.4% of investments.

India's merchandise exports in FY 11 accounted for 13% of the total exports to US (total exports were US $ 246 bn). India's software exports amounted to US$ 59 bn of which 60% were to the US in FY 11. India has a debt GDP ratio of 70 – 72%. India's problem is again uncharacteristic. It's sometimes a case of many a slip between the cup and the lip and many a times a case of lack of political will. Given the huge income gap amid the urban and the rural areas, schemes like NREGA will have to persist in order to lend a hand to the poor and converge on the gap putting reform ideas on a back seat.

India's strengths are its domestic driven economy where consumption is at about 70% of the GDP and its loaded demographic dividend. It isn't as outwardly stringed to the rest of the world as the other economies of the world given that exports account for about 16% to 17% of the GDP and as yet India is not fully convertible on the capital account. Problems that plague India are that it is presently on the brink of running a higher than budgeted fiscal deficit, governance issues which seem to be taking it by storm, towering inflation and moderating growth.

India's growth story seems to be on a moderation turn now with Q4 (Jan – March) FY 11 GDP nos coming in under 8% levels and Q1 FY 12 GDP at 7.7% levels. Factory output has not been too strong with monthly data reflecting some narrowing trends in business confidence. Growth for FY 12 might fall in the 7.5% - 8% band from 8.5% seen in FY 11.

But more than growth it is inflation which worries the Indian economy. Both WPI and CPI have been over 9% over the past one and half years now. Besides global commodity prices, it is also high food prices, fuel price deregulation, increased MSP (MSP – a price which the government guarantees to the farmers to protect them from increased production costs) for certain items of the food basket such as paddy and other kharif crops as well as edible oils among others which have triggered inflation. The impact of changes in global commodity prices on domestic inflation is huge given almost 65% of the WPI is dedicated to commodities. India is highly import dependent therefore any increase in fuel prices will have it impact on inflation. Every 10% increase in crude oil prices if fully passed through to domestic prices could have direct impact of 1 percentage point increase on WPI directly and over 2 percentage point increase over time as input costs increase.

Another hitch with India is more than inflation it is the modus operandi used to battle inflation which looks blurred. Both fiscal and monetary policies need to balance each other to affix inflation and inflationary expectations. Nevertheless in India RBI has done more than it can and remunerated for the government to go all out to tackle inflation while the government remains a reticent onlooker. Not much has been done to embark upon the supply side ambiguity and plug the PDS system which has been fuelling prices since long. The RBI has raised policy rates by 325 bps but most of the hikes have had little impact on growth and inflation. Partially this can be ascribed to the imported incident of inflation and in some measure to the other factors listed above. The saving grace is that the RBI continues its hawkish standpoint. But inflation is expected to stay sticky for a while and should cool

off in the latter part of the current year and may likely come in at about 7% - 7.5% by end March 2012.

India like the US and the rest of the world is also living beyond its means. The fundamental problem for India like everyone else in the world is that the government expends more than it earns. In FY 11 the government spent over Rs 12 lakh crore while it earned about Rs 8 lakh crore. So then it has to route to borrowing which enhances the interest rates. The salt to the wound comes in the form of the additional spending the government wants to assume in terms of giving subsidized food to 75% of the people via the food security bill and increased wages to the rural poor via NREGA. Although this profits the rural people, everyone in the economy pays for it. Looking closely at the subsidy bill, it posts a 12.5% contraction on a yoy basis factoring in modest assumptions on the fuel front. But a back of the envelope calculation shows that even if fuel is taken at US$ 100 / bbl, it would give rise to gross under recoveries over Rs 1000 bn. The budgeted fuel subsidy amounts to Rs 236 bn. The table below indicates that if the government share is kept almost at similar levels as the share undertaken in FY 11, the oil subsidy bill could rise upto Rs 505 bn for the government compared to the budgeted Rs 236 bn. Incase oil prices post further increases there could be upside pressure to this estimate.

Table 1. Subsidy Sharing Mechanism

Subsidy sharing	FY 08	FY 09	FY 10	FY 11	Q1 FY 12	FY 12 BE
Gross under recoveries	772	1037	461	782	432	953
Less diesel de-regulation						
Less: upstream sharing	257	329	144	303	144	381
% of total	33%	32%	31%	39%	33%	40%
Less: oil bonds/cash	353	713	260	410	0	505
% of total	46%	69%	56%	52%	0%	53%
Net under recoveries	163	-6	56	69	288	67
Crude (US$/bbl)	82	85	70	86.6	118	102

Source: Budget Documents

Table 2. Subsidy Bill

	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12 BE
Subsidies	475	571	709	1297	1414	1642	1436
% GDP	1.3	1.3	1.4	2.3	2.2	2.1	1.6
Food	231	240	313	438	584	606	606
Fertilizer	185	262	325	766	613	550	500
Petroleum	27	27	28	29	150	384	236
Others (incl grants)	33	42	43	65	67	102	94

Source: Budget Documents

The other issue arises from the food bill. Food bill has been budgeted at Rs 606 bn a flat year on year growth. Food subsidies account for about 50% of the total subsidies and are pegged at Rs 606 bn. If the National food security bill is introduced it would demand an additional outlay anywhere in the range of Rs 100 bn to Rs 200 bn depending on when it actually gets implemented. Besides the costs incurred due to reimbursement to the Food Corporation of India for procurement, transportation etc amounts to another Rs 347 bn which will be added to the bill.

Table 3. Projections for Food Subsidy

	NAC projection (90% offtake)	EC projection (100% offtake)
Priority households	576.5	664.1
General households	222.8	256.5
Total subsidy requirement	799.3	920.6
Subsidy in FY 11 (initial est)	567	567
Aditional subsidy over FY 11	232.3	353.6
foodgrain requirement (mn tonnes)	63.6	74

Source: Budget Documents

On the fiscal front, deficits have been a feature of almost all developing economies which have been tuned into the obligation of investing for future growth, principally in a situation of a savings investment disparity. In 1991, when India plunged into a crisis, fiscal deficit levels were as high as 10%. Clearly the fiscal situation got out of hand as it gobbled up a tenth of the GDP. India's fiscal deficit was at a 16-year high of 6.7% of GDP in FY 10. In FY 12, India seems to be in for a rough landing again.

The government budgeted Fiscal deficit at 4.6% of the GDP for FY 12. But that now seems to be a far cry. The 4.6% fiscal deficit target was made on the hypothesis that the fuel subsidy bill would not surpass the budget provision of Rs 236 bn and there would be no shockers on the food and fertilizer subsidy front as well. But fiscal slippage is categorically possible as has been discussed above. On the fertilizer front, given that fertilizer prices have augmented and taking into account deferred pass through of market prices in terms of oil etc are impending stress points which will contravene the budget estimate which implies a likely prospect of crowding out private investment. Fertilizer subsidies account for 45% of the total bill. It has increased from Rs 132 bn in FY 2000 to Rs 500 bn in FY 12. Out of the Rs 500 bn, the provision for potash amounts to Rs 297 under the nutrient based scheme. India entirely imports Potash which is priced at US$ 420 per tone. This should further add pressure to the bill although the extent of pressure is proportionate to the prices at which it is sold. Taking into account the revenue losses from the duty cuts on petrol (Rs 490 bn which is 0.6% of GDP) and the expenditure overshoot on account of subsidies, fiscal deficit for FY 12 might border around 5.5% of the GDP.

Table 4. Fiscal snapshot

	Fiscal Bal						
	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12
Fiscal Bal	-1464	-1426	-1270	-3370	-4185	-4010	-4128
% to GDP	-4	-3.3	-2.5	-6	-6.4	-5.1	-4.6
Rev Bal	-923	-802	-526	-2535	-3390	-2698	-3073
% to GDP	-2.5	-1.9	-1.1	-4.5	-5.2	-3.4	-3.4
Primary Deficit	-138	77	441	-1448	-2054	-1602	-1448
% to GDP	-0.4	0.2	0.9	-2.6	-3.1	-2	-1.6

Source: Budget Documents

In terms of current account deficit, CAD has been kept under check due the the large capital flows India has received through the FII route in the past. But the crisis which hit the EU last year impacted India with a drop in FDI inflows at US $ 17 bn in the first ten months of

FY 11 compared to ~ US $ 23 bn seen in the same period of FY 10. Germany, France, Netherlands and UK are some of India's main investors. The crucial consideration however is the ability of the economy to service the deficit and the confidence foreign investors have in that ability. For India, CAD has been below 2% of GDP until FY 09 but with increasing need to build adequate infra support to sustain growth, it is possible to absorb foreign savings to the tune of 3% of GDP without much upheaval. More than deficit it is channelizing the inflows productively and sustaining the confidence of investors which should be the concerns going forward. India is way down in the rating ladder at BBB. What India needs besides political will and intent to grow is a strong and sustained capital investment pace in order to help fuel economic growth.

With the US, EU and Japan facing their own problems and coiled up in a crisis condition of their own, possibly with its anticipated headline GDP growth of about 8%, relatively protected bond markets (debt is internalized) and highly regulated banking system (30 percent of deposits go into statutory reserves) India could clutch the opportunity now. What India has is - a commendable body of legal and policy framework. But what India needs is to focus on strategic implementation.

The links connecting macroeconomic management and financial development are insightful and run in both directions. Whatsoever their liabilities might be, India's macroeconomic policies have conveyed high growth and, until recently, stable inflation. A lot of meaningful reforms need to be fed into the system to make the economy more supple and set it up for a solid and concrete growth trajectory. Both monetary and fiscal policy reforms coupled with the other imperative component of financial inclusion is the need of the hour.

Lack of state of art Infrastructure is another impediment to India's growth. Investments in infrastructure have not kept pace with the growth in GDP – from 1988 to 2005 the investments amounted to 4% of the real GDP (compared to China's 8.2%). Only recently, there has been a boost in infrastructure spend, reaching 4.7% of the GDP (USD 35 billion) in FY 2006. In order to achieve a growth rate of 9% for the economy (GDP growth rate), infrastructure expenditure should increase to 9% p.a.

The 11th Plan (April 2007 to March 2012), has placed a heavy emphasis on infrastructure investment. The projected expenditure of about US $ 500 bn during the plan period is estimated to result in gross capital formation of about 8%. Nevertheless, numerous challenges such as regulatory policies, land acquisition, and skilled labour and equipment shortages etc continue to impede investment in the infrastructure space. Also the SEZ Act needs to be taken to its subsequent logical step - providing support to the development of green field sites swiftly and economically. Market determined pricing of utilities should be put in place. Focusing on building infrastructure ahead of demand in a scalable manner, rather than to meet minimally the contemporary demand along with synchronized efforts to fortify rural infrastructure and make available a discernment of long-term value in the Projects would go a long way in feeding growth. An accord is required between fiscal and monetary policies as well as a concerted effort towards healthy governance. This alone could add appreciably to India's economic growth and also make a key contribution to the sustainability of this growth, in both the economic and the political dimensions.

In the absence of qualitative reforms india might keep spending more than it would be earning and wind up in a crisis of its own like most countries of the world today. Tactical management, thrust on innovation and research, efficient policy reorganization and strong

political resolve are clear rudiments for India in contemporary times. For India the triple crisis plaguing the global economy is undeniably more an opportunity than a complexity. The time is indeed ripe for India.

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