Comments on NCAER's Mid year review of the economy

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This review offers an opportunity to take stock of some conundrums in the economy. The review has addressed some puzzles such as : Why has there been a slowdown in growth? Why is the investment rate low? Why is inflation in manufacturing low and how does this tie up with liberalisation, supply side and demand constraints? Other issues, some old, some new also need to be addressed. We shall now address some of these.

Agriculture

Agricultural policy continues to be food-grain centric. Not only do the government's policies on subsidies, food prices etc aim to benefit a small group of surplus producing foodgrain farmers, even critics of the government focus their energies on policies related to food grains. Thus debates on procurement prices, inter-state trade restrictions and food stocks still dominate policy circles even when cereals account for only 26 per cent of the value of output of agriculture, livestock and fishing.

The focus on cereals is at the cost of other issues. For instance, the decline in productivity of both land and labour in agriculture as a whole has been ignored. It is worrying that the average growth rate of crop production fell from 3.2 per cent in the 1980s to 1.7 per cent in the 1990s. Growth of yields fell from 2.6 per cent to 1 per cent.

However, despite government apathy and lack of support there has, in the last 20 years, been a diversification into high value products such as milk, fruit, vegetable, livestock and fishing. Interestingly, this has been a demand driven revolution as incomes have risen and food baskets changed with urbanisation. PFCE on cereals and bread has come down from 18 per cent in the 1970s to 9 per cent in 2001.

Recent studies reveal disturbing trends. While in the 1980s there was a sharp increase in production, there is a slowdown in the 1990s. This is mainly because the 1980s saw a sharp rise in yields, but now technologies have stagnated and yield levels plateaued.

Question: Is it not time to re-examine our agricultural policy?

Debt

The fiscal costs of these bailouts will be enormous. Moreover, these will not be merely the numbers that are currently floating around such as the Rs 14,000 crore figure for the UTI bailout. The future fiscal costs of these bailouts will be much higher. Bailouts create moral hazards for public sector financial institutions, including PSU banks, who will believe that mismanagement goes unpunished. They will now be convinced that they have unlimited claims over public money. Indeed, after these bailouts the size of the government's internal debt should be measured *including* its guarantees to public sector banks and financial institutions. This clearly raises the level of public debt sharply. The debt figure above also does not include guarantees provided by governments. The explicit guarantees provided by the central government stand at 4.2 per cent of GDP. For State governments the situation is even worse. While explicit guarantees stand at 8.1 per cent of GDP, implicit guarantees are yet to be measured. Only a few states have placed ceilings on guarantees.

Question: Should we not have a good measure of the size of the fiscal deficit taking contingent liabilities into account?

FOREX reserves

In fact, an important reason why the reserves built up was that had not the RBI bought up the dollars that were flowing in, the rupee would have appreciated. It was as much to prevent this as to obtain protection against the sanctions that the reserves built up to such a high level. The build-up of India's foreign exchange reserves over most of last year has, in a sense, been involuntary. At the end of March 2001 reserves were nearly $40 billion.

About $30 billion would have provided six months of import cover. Another $10 billion could have been put aside for protection against the flight of portfolio investment. The reserves would have provided for servicing India’s $100 billion of external debt without having to resort to borrowing. Despite the slack performance of Indian exports there was an upward pressure on the rupee. Left to the market, the rupee could have appreciated and adversely affected export performance even further. To prevent the rupee from appreciating the RBI bought dollars and thus unwittingly added to reserves which now stand at $64 billion.

The way the exchange rate is measured by the RBI has been to estimate the Real Effective Exchange Rate that takes into account nominal exchange rates and inflation rates of trading partners. There are issues of weights, base period, trading partners and competitors that figure in the discussion on trends in the real exchange rate, but in general, it is found that the REER does not indicate any serious appreciation of the Indian Rupee. However, it seems that the weights include currencies of trading partners in India’s merchandise trade. Since services now constitute over 30 per cent of India’s exports, it is possible that if the measure took this into account the REER would behave differently. Estimates of the effective exchange rate do not measure prices of traded goods which may be difficult in the case of services, but involve assigning weights according to trade of goods and services and not merely goods and is so not very difficult to implement.

While India’s merchandise exports grew by nearly 2.5 times over the decade of the 1990s which undoubtedly saw many steps to liberalise and to raise exports, the exports of commercial services quadrupled. It is therefore time to re-examine the traditional concepts of merchandise as ‘tradable’ and of measuring real exchange rates vis-à-vis merchandise. As India’s productivity in the tradables sector, that now includes services, increases, there would be a tendency for the rupee to appreciate. But if the rupee is not allowed to appreciate and if the trends in service exports continue, it would be difficult to run current account deficits that match the savings and investment projections of the economy.

Question: Is India's exchange rate policy consistent with her policy of importing capital and running current account deficits? Is the rupee not undervalued today?

Labour

One of the reports – by the Taskforce on Employment that had been headed by Montek Singh Ahluwalia when he was a Member of the Planning Commission – recommended changes in labour laws. The other, more recent, Special Group on Employment – headed by S P Gupta says that new jobs have to come from the unorganised sector. The task force headed by Ahluwalia had recommended acceleration of GDP growth to achieve higher employment growth. This could come about through substantially higher investment and an increase in the efficiency of capital use. It argued that Indian labour laws have impeded the flexibility to adjust the labour force affecting investment and the growth of employment.

The most radical change recommended by the task force was the abolition of the requirement of prior government permission for retrenchment, lay-offs or closure by a change in the Industrial Disputes Act. It also recommended the introduction of a system of short term employment contracts under which workers hired on contract basis can be fired. These workers could be paid higher wages to compensate them for the uncertainty of the contract. Further, it recommended ammendments to the Contract Labour Act to allow all peripheral activities to be freely outsourced from specialised firms.

Employment data shows that it is the unorganised sector that has allowed employment generation to keep up with the growth in labour force. When labour force grew at 2.29 per cent in the period 1987-94, employment grew at 2.43 per cent. In the following years from 1993-2000, employment growth of 0.98 per cent was close to the labour force growth of 1.03 per cent. The Special Group concludes, it is the unorganised sector that should be encouraged to grow. But it is not the solution unless India is aiming for low labour productivity, low real wages and low incomes. Unless employment growth comes with higher GDP growth and higher productivity, it will continue to result in low wages and low standards of living. If labour productivity is to increase, production must take advantage of economies of scale. This can only happen if there is massive investment in the industrial sector i.e. the organised sector.

Question: Is it possible for India to have high growth in employment in high productivity sectors without a change in labour laws?