From Council to Plan, finding a middle path

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The economic outlook for 2006-07 presented by the Economic Advisory Council to the Prime Minister has no startling revelations. It however serves the purpose for which the Council was created—of providing periodic and independent updates on the state of the economy to the Prime Minister. The growth performance did enable the Prime Minister to assert with confidence that for the third year in succession economic growth would be 8 per cent. This is underpinned by a projected 9.8 per cent growth in industry, and in the services sector at a slightly decelerated level of 10.5 per cent.

Agriculture continues to be uncertain with adverse weather yielding at best a 1 per cent while good monsoon taking the growth to 2 per cent. In an overall context, the report argues that growth in recent years has been consumption-driven, supported by demand for homes, financed through easy loans at low interest rates. In terms of prescription, it argues in favour of an investment-led than a consumption-driven growth.

It has become fashionable to suggest that while China needs to move to a consumption-driven growth, the Indian growth must be investment-driven. To some extent there may be an oversimplification in this approach because, as Stephen Roach of Morgan Stanley argues, ‘‘If China were a pure market economy with relatively stable financial institutions then a revaluation of the Renminbi would be appropriate, but China’s not there. I think we (the US) need to grow slower, and if the rest of the world is not willing to pick up its own internal demand to offset that, then the world deserves to grow slower—that’s the bottomline.’’

In tangible terms, for India, the Advisory Council expects the following:

i) Investment capital to be made available at reasonable rates of interest;

ii) The Government reducing its fiscal deficit, particularly revenue deficit;

iii) The Government to provide more and better infrastructure;

iv) Investment in infrastructure by way of direct public investment or through public-private partnership.

Going forward, it projects that the net accretion to resources will slow down with slight deterioration in the current account balance, but its financing will be sharply increased from FDI flows, estimated to be $8.5 billion against the Reserve Bank’s projection of $5.7 billion, and a marked slowdown in portfolio flows from the levels achieved in the previous year. The report concludes that, in projecting a growth rate of 7.8-8 per cent, one would hope this is investment-driven and that ‘‘the growth momentum can be maintained if the Government can create a conducive climate for private investment through strong supply-side response mainly in two ways—improve the ...infrastructure and make credible fiscal adjustment so as to release resources for private investment. Some hardening of interest rates is inevitable to restrain inflation, and expect the WPI inflation to be around 5.5 per cent’’.

The prescription is somewhat at variance with the Government’s thinking in this regard at least on four contents:

First, the Eleventh Five Year Plan target of an average 8.5 per cent GDP growth may not look so unrealistic if the growth momentum of the last three years can be sustained. However, the resources for the Eleventh Plan for an 8.5 per cent increase as a percentage of the GDP are expected to be 9.43 per cent and the Gross Budgetary Support to the Plan has to increase substantially to over 5 per cent. This is not in line with the targets contained in the Fiscal Responsibility & Budget Management (FRBM) Act, and the Plan says that ''this raises the issue of whether the FRBM targets should be waived further by say two years and (that) an alternative projection and profile of investment requires a modification of the Act or at least the rules on the fiscal deficit targets, not to be specified in absolute terms but to be cyclically adjusted in keeping with international best practices''.

In simple terms, whereas the Economic Advisory Council would like fiscal deficit to be significantly moderated in view of its crowding-out effect, the Eleventh Plan is predicated on a more flexible approach on fiscal targets. Similarly, on the revenue deficit, the Advisory Council report would like its elimination as quickly as possible whereas the Plan, for good reasons, argues that conceptually revenue expenditures are not so undesirable and their targeted elimination not in line with best international practice.

Second, on interest rates, while the Council expects some inevitable hardening, the continuation of a more accommodative regime is an underlining assumption in the Plan and the Finance Ministry's reaction in asking banks to seek their Board approval was not merely observance of procedural propriety but an indication of a dissuading rise in interest rates which could decelerate the current growth momentum.

Third, nobody can deny the need for better infrastructure nor question the need for public-private investment, even though the continuation of large public investments has fiscal implications. More than that, working with public-private partnership and securing the large investments which are needed still represents a learning curve with uncertain outcomes, especially in creating acceptable models for replication by state governments.

Fourth, the Council, while expecting the continuation of the current account deficit, visualises significantly large FDI flows and marked slowdown in portfolio resources. Notwithstanding some recent increases in FDI flows it is not clear whether, without other significant policy changes, private investments in general and FDI flows in particular would rise significantly.

The Executive Summary of the Advisory Council's report largely deals with key macro variables. Structural changes, particularly in sectoral issues like energy, agriculture or infrastructure, have not been analysed. Some of these may hold the key to securing larger private flows as indeed the resolution of some important policy changes contained in the Eleventh Plan paper. Even on the broad macro framework there are some incongruities in the prescription of the Advisory Council and the policy package contained in the Eleventh Plan.

Not all bodies can think alike. Their divergent perception alters the policy prognosis. Plurality of views in a federal polity always makes for improved consensus.