

II The Theme of The Report

2.1 Against the backdrop of macroeconomic developments in India during 2001-02 set out in the foregoing Chapter, the Report on Currency and Finance for the year 2000-01 attempts to address the various issues relevant for “Revitalising Growth” as its theme. The choice of the theme is in recognition of the growing national impatience with the continuing deceleration in economic activity and the debate surrounding the effectiveness of macroeconomic policies in initiating the upturn. The approach of the Report is analytical, eclectic and indicative with a preference for verifying testable hypotheses that emerge in the treatment of the various inflexions surrounding the theme of the Report. The findings from these analyses are presented in the form of simple, explanatory charts and tables in the text of the Report. All through the Report, the endeavour is to employ charts and illustrative representation of the key points in the discussion. In a sense, the Report on Currency and Finance essentially picks up the cues given in the Reserve Bank’s Annual Report, 2000-01 and provides them with form, analysis and leading information content against the horizon of medium-term strategies being envisaged for the economy. Including this Chapter (II), the Report is divided into eight chapters.

2.2 The first Chapter entitled “Overview” provided a brief commentary on the Indian economy as a backdrop to the theme-based chapters which follow. It focused on developments during 2001-02 up to the end of December, 2001, dealing with them in terms of continuation of trends observed in 2000-01 and significant reversals, particularly in the context of the theme of the Report. Thus, the Report completes a quarterly cycle of reporting macro-developments, along with the “Macroeconomic and Monetary Developments” issued in conjunction with the Statement of Monetary and Credit Policy reviewing the economy up to March, the Bank’s Annual Report up to June-July and the mid-term review of Monetary and Credit Policy up to September-October.

2.3 Chapter III is entitled “Exploring the Slowdown”. Starting with a brief discussion on the current debate on the deceleration in the economy, the Chapter attempts to identify the underlying factors in the downturn. It undertakes an analytical examination of cyclical and structural influences on the actual and potential growth path of the Indian economy, the structural breaks in the growth process and the turning point beginning the downturn. A profile of aggregate demand in the economy – consumption, investment, net exports – is presented with a view to gaining an understanding of the cyclical changes in the growth process so as to provide pointers for the allocation of resources for reinvigorating the impulses for growth from the demand side. The Chapter also deals with the structural constraints to growth - gaps in the modernisation of agriculture, infrastructure, capacity utilisation and technology. In addition, the chapter addresses the role of services as a lever in the growth process, identifying various linkages which services sector growth has for the rest of the economy. Further, the regional dimensions of growth in India against the backdrop of state-level reform with an emphasis on various human development and demographic indicators among various Indian states are also examined in this Chapter.

2.4 The fourth Chapter entitled “The Role of Fiscal Policy in Reinvigorating Growth” addresses the ongoing debate in India on the role of fiscal policy in reversing the slowdown and stimulating the revival. The approach of the Chapter is in terms of a combination of a review of

the specific literature and the cross-country experience in the 1980s and 1990s. Fiscal strategies based on expenditure restraint, strengthening of the institutional framework for fiscal policy, raising accountability and improving credibility through transparent fiscal rules are reviewed in terms of their efficacy against a recession/downturn. The growth implications of alternative fiscal mixes are evaluated with the help of a small econometric model to determine growth stimulating combinations of fiscal instruments. An important exercise conducted in this Chapter is the estimation of the 'cyclical' and 'structural' components of the fiscal deficit in order to ascertain the effects of automatic and discretionary stabilisers in fiscal policy. The response of private consumption and investment to fiscal policy are tested to investigate 'crowding-in' and 'crowding-out' effects associated with fiscal activism. The Chapter also addresses the issue of fiscal sustainability from the point of view of the impact of fiscal policy on future growth performance. In view of the arguments in the current debate in favour of 'pump-priming' *via* monetisation, the Chapter examines the issue by testing the hypothesis of 'unpleasant monetarist arithmetic' in search of a critical mix between bond and money financing of the fiscal deficit in the context of the revival of growth. This is expected to be a key input in the context of the evolving framework of monetary-fiscal coordination in India.

2.5 Chapter V, which is entitled "Growth, Inflation and the Conduct of Monetary Policy", joins the current debate relating to the role of monetary policy in stimulating the revival. It undertakes an appraisal of the unsettled debate on the neutrality of monetary policy and explores the location of the threshold level of inflation in India as a proximate solution to the neutrality debate. The sacrifice ratio is estimated to check for the losses of output that can occur from disinflationary policy pursued at below the threshold inflation. The interest rate channel of monetary policy is examined in the context of the modern tradition of 'consensus monetary models' with a view to providing the analytical underpinnings of the current monetary policy framework. The credit channel of monetary policy is also empirically examined within the framework of a small, simultaneous model of the macroeconomics of the market for bank credit in India. The Chapter also deals with the constraints on monetary policy – the issue of time inconsistency, the threat of deflation in the context of the current global disinflation cycle and the solutions sought in the Indian context.

2.6 In the 1980s and 1990s, many developing countries have liberalised their policy regimes to employ foreign capital as an accelerator of growth. Chapter VI entitled "External Sector and the Growth Process" studies the role of capital flows in India's growth dynamics based on a review of the theoretical and empirical literature, an examination of the cross-country experience, and the stylised facts in India. The relative efficacy of export-led growth and capital-induced growth are contrasted and the evidence suggesting strong complementarity between capital flows and domestic investment is presented. The core of the Chapter is an empirical evaluation of the testable propositions relating to the growth-driving/ growth-driven characteristics of various forms of foreign capital. The growth-augmenting role of foreign capital in India appears to have been constrained by the low levels of actual and planned absorption of foreign capital, creating the illusion of 'abundance of capital' in India in the 1990s. These findings place the Tenth Plan growth objective and the associated external financing projections in a perspective.

2.7 Chapter VII entitled "Resource Allocation and the Financial System" examines the role

of the financial system in the development process in India, particularly its transition from a passive mobiliser of financial resources to an efficient intermediary with the phasing out of administrative controls over the capital markets and the banking sector. In order to assess allocative efficiency, the Chapter explores several alternatives. The role of the banking system, which is relevant in the context of a predominantly bank-based model of financial development as in India is compared against the capital market, which is progressively assuming greater importance in the distribution of national saving and investment.

2.8 The final Chapter, entitled “A Macroeconomic Summary of the Economy”, essentially summarises the principal findings of the preceding chapters with the objective of evaluating the consistency of the various points made in the Report in terms of a complete system of macroeconomic relationships. Various exercises conducted in the other Chapters feed into the core ‘model’ either recursively or in the form of off-model calibrations. The Chapter sets out the framework for assessing the behaviour of the real sector by examining the growth dynamics operating through the fiscal sector, the monetary sector and the external sector. The thrust of this Chapter is to outline an operational framework for analysing interaction of major economic agents (households, producers, government) behaviour in the medium to long run.