Critical Issues and Challenges of The Indian Economy

ASMITA NAGPAL[1] NITIN YADAV[2]
M.B.A(HR &FIN.), M.Com, B.Ed, NET in Management[1]
M.B.A(HR&MKT.), NET&JRF in Management[2]

Abstract

The Indian economy has undergone a remarkable transformation over the past two decades. The growth rate of average incomes has increased from 1¼ per cent prior to 1980 to 7% by 2006. Faster growth has been brought about by a paradigm shift in economic policies that has opened the economy to foreign trade and markedly reduced direct tax rates and government influence over most investment decisions.. For the past three decades, Indian economy has grown tremendously, at an average annual rate of 6.4%.From 2002 to 2011, when the average rate was 7.7%, India seemed to be closing in on China-unstoppable. Despite this outstanding performance, there is still much room for improving policies. But India's self-confidence has been shaken, growth has slowed to around 5% a year after 2011.This paper first looks at India's economic history and then identifies a number of key challenges and issues that economy is facing .By addressing these issues properly, the growth could be faster, more sustainable and more even across the country.

Objective of Paper

- To throw some light on key issues and challenges of the Indian economy
- To provide some suggestions regarding these challenges

Research Methodology

This paper attempts to give a brief idea on economic history of India and gives an understanding and effects of some critical issues of the Indian economy that needs to be addresses properly in order to sustain the economic growth of the country using materials from past research and secondary data.

Keywords: Indian economy, critical issues, growth etc.

Introduction

India, a country of 1.2 billion people has the economy which is the 9th largest in the world by nominal GDP and 3rd largest by purchasing power .As predicted by various financial institutions like, Goldman Sachs, the global investment bank, by 2035 India would be the 3rd largest economy just after USA and CHINA.

The economic history of India can be broadly divided into three phases:

- *Pre Colonial:* this phase include the economic history of India since Indus valley civilization to 1700 AD. During this phase Indian economy was very developed. It has very good trade relations with other part of world, which is evident from the coins of various civilization found at site of Indus valley. Before the advent of East India Company, each village in India was a self sufficient entity and was economically independent as all the economic needs were fulfilled within the village.
- *Colonial Indian Economy:* Advent of East India Company caused a huge strain to the Indian economy and there was a two-way depletion of resources. The British would buy raw material from India at cheaper rates and sold finished goods at higher than normal price at Indian market. During this phase India's share of world income declined from 22.3% in 1700AD to 3.8%in 1952.
- *Post Colonial Phase:* The process of rebuilding the economy started after getting independence from colonial rule in 1947.First five year plan for the development of Indian economy came into implementation in 1952.These five year plans, started by Indian government, focused on the needs of the Indian economy. If on one hand agriculture received the immediate attention on the other hand the industrial sector was developed at a fast pace to provide employment opportunities to the growing population and to keep pace with the development in the world. Since then Indian economy has come a long way. Trade liberalization, financial liberalization, tax reforms, and opening up to foreign investment as an economic liberalization introduced by Man Mohan Singh in 1991, then finance minister in the government of PV Narasimha Rao, proved to be the stepping-stone for Indian economic reform movements.

For the past three decades, Indian economy has grown impressively, at an average annual rate of 6.4%.From 2002 to 2011, when the average rate was 7.7%, India seemed to be closing in on China-unstoppable.

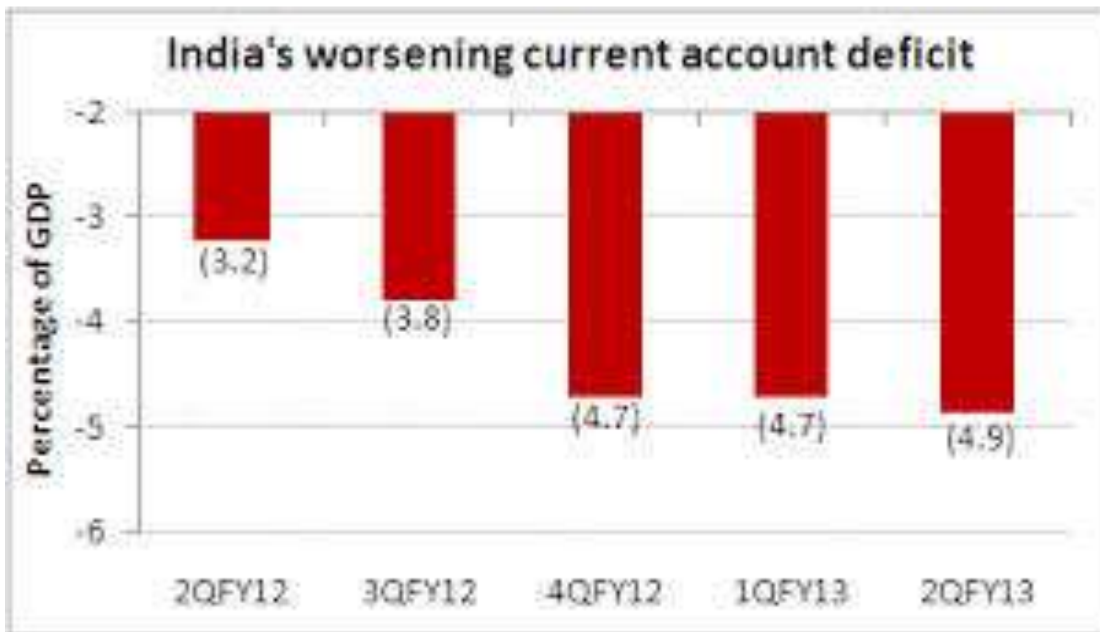
But India's self-confidence has been shaken. Growth has slowed to 4.4% a year .This has happened because of not addressing the critical issues properly, that are focused as under:

Key Issues and Challenges for the Indian Economy

Current Account Deficit (CAD)

CAD, which is the difference between the inflow and outflow of foreign exchange, stood at USD 45 billion in 2013-14.CAD occurs when a country' total imports are greater than the total exports. This situation makes a country a net debtor of rest of the world.

A deficit happens when a country's government, businesses and individuals exports less goods, services and capital from foreigners than they import.CAD is usually measured as a percentage of GDP (gross domestic product). GDP refers to the total market value of the goods and services manufactured within the country in a financial year.



Source: www.livemint.com

Components of Current Account Deficit:

A) *Trade deficit:* trade deficit means the country imports more goods and services than it exports. India's trade deficit stood at USD 9.22 billion in November. An ongoing trade deficit weakens a country's economy over the long term because it is financed with debts.

B) *Net income*: the second component is usually a deficit in the net income. If the income paid out by a country's individuals, businesses and government to their counterparts is more than they receive, it contributes to a deficit.

Net Income = income earned on foreign assets owned by a country's residents and businesses – payments made to foreigners who owns assets in the country, and wages paid to foreigners.

C) *Direct transfers*: the third component of the deficit is direct transfers, which includes government grants to foreigners. It also includes any money sent back to their home countries by foreigners.

- Specially, deficit is increased by these direct transfers.
- Wages sent back to a foreigner's home country.
- Government grants made to foreigners.
- Bank loans to foreigners.
- Direct investments made by abroad by a country's residents.

Implication of a large deficit:

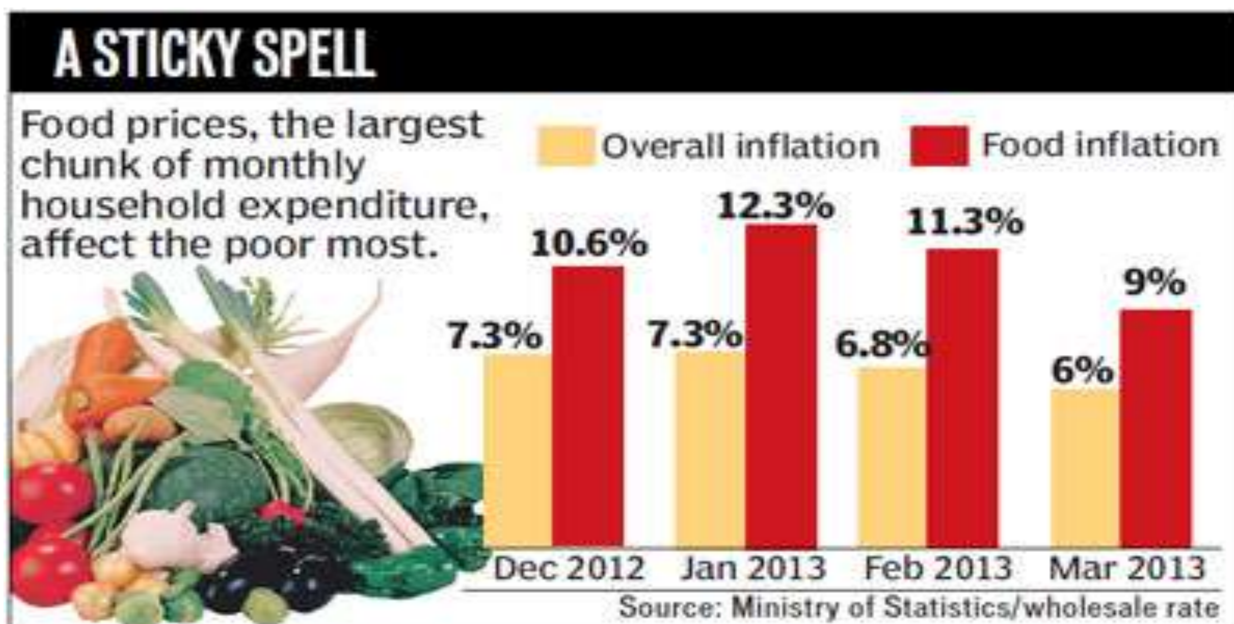
In January 2013, the finance ministry said that India's record current account deficit is "worrying". Deficit on the current account means a net outflow of foreign exchange. In India's case, this means a dollar outgo. Such a deficit could drain the country'sforex reserves if inflows to make up the deficit do not materialize. Therefore, a country with a current account deficit has to attract capital flows, which could be in the form of, say, foreign direct investment, to meet the shortfall. But when capital flows are insufficient to meet the deficit, the country's currency starts to depreciate on concerns that it may find it difficult to meet its international commitment or fund its current purchases. A current account deficit in excess of 2.5% of GDP is seen as worrisome in case of India

High Inflation

In economics, inflation is a persistent increase in the general price level of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services.

The inflation rate in India was recorded at 8.79 percent in January of 2014. Inflation Rate in India is reported by the Ministry of Commerce and Industry, India. The Wholesale Price inflation rate data is available at Producer Prices Change. Inflation Rate in India averaged 9.83 Percent from 2012 until 2014, reaching an all-time high of 11.16 Percent in November of 2013 and a record low of 7.55 Percent in January of 2012. Historically, the wholesale price index (WPI) has been the main measure of inflation in India. However, in 2013, the governor of The Reserve Bank of India, Raghuram Rajan had announced that the consumer price index is a better measure of inflation.

Inflation has been one of the most important problems facing India's economy. Over the past five years (2006-11), the annual average Consumer Price Index (CPI) inflation was 8.7 percent for industrial workers and 9.7 percent for agricultural laborers, while the Wholesale Price Index (WPI) inflation was 6.3 percent. India's CPI inflation has been the second highest among the Asian economies.



Source: Ministry of Statistics/wholesale rate

Nomura economists have identified five reasons for the consistent uptick in inflation:

1) *Capital Stock Deficiency:* Capital stock deficiency tends to lead to bottlenecks, under which resource constraints, including limited infrastructure and/or the lack of manufacturing capacity delay overall production or service generating processes, further leading to higher inflation through shortages in supply. India's capital stock-to-GDP ratio was 1.79 in 2010, among the lowest in Asia.

2) *Demand Side Drivers (The National Rural Employment Guarantee Act(NREGA):* Nomura economists said demand-side inflation drivers, especially those arising from a sharp rise in personal income and an expansionary fiscal policy, have also played an important role in keeping inflation persistently high.

3) *Food Price Pressures*: Food price inflation has been a major driver of inflation and the lack of rainfall during the monsoon season often hits India's food production. In addition, the structural change in food intake has contributed to food price inflation.

4) *Import Price Pressures*: Import price pressures have also been an important factor for overall inflation as India has become a more open economy over the past 10 years. In fact, the imported goods-to-GDP ratio doubled from just above 11 percent in FY00/01 to 21.9 percent in FY10/11 with bulk imports, such as crude oil, metals, rubber and food - primarily commodity-related items - accounting for 42.7 percent of total imports.

5) *Inflation Expectations*: In the RBI's latest inflation expectations survey of households, respondents' inflation expectations for three months ahead inched up to 12.2 percent in the third quarter of 2011 from 11.8 percent in the second quarter. Overall, inflation expectations have been largely driven by food price inflation in India as food constitutes more than 50 percent of the average Indian household's consumption basket.

Although we expect cyclical factors to ease WPI inflation to 6-7% in 2012-13, we believe structural factors will likely lead to a resurgence of high inflation in the medium term so long as investment growth remains subdued, economist Tomo Kinoshita wrote in a note to clients.

Nonetheless, the economist said simulation analysis suggests India can lower its inflation considerably if it achieves high investment growth via various reforms.

Food price inflation has become a major problem in India over the past few years. Price stability is crucial for sustainable growth, as persistent inflation implies higher demand relative to supply. Thus, there is an urgent need to understand this problem and to respond with appropriate agricultural policies to keep food prices stable if we are to reduce hunger and poverty in India. One reason for the rising food prices could be increasing demand for food, as income levels increase with rapid economic growth. Another reason could be supply and distribution problems. Another factor could be the increasing diversion of cereals such as corn to production of bio-fuels, especially in USA , that eventually also reflect in other countries through international food markets. However, imports of food, especially cereals, are relatively small in India’s case, so food inflation is likely to be driven mainly by domestic factors.

Effects of High Inflation on Economy

In an economy in which the prices of everything, including the prices of assets and debt instruments, changed proportionally with the price level, nobody would be hurt by our benefit from changes in the price level, unless those changes affected the economy's output and the rate at which that output grew. However, in the real economy, all prices do not change at the same rate. Consequently, inflation does provide gains to some and losses to others, apart from any effect on the output level and its growth rate

(A)Effects on the distribution of income and Wealth

There are two ways to measure the effects of inflation on the redistribution of income and wealth in a society: (i) on the basis of the change in the real value of such factor incomes as wages, salaries, rents, interests, dividends and profits. Here, income is narrowly defined, (ii) on the basis of the size distribution of income over time as a result of inflation. The change in a household's net worth from one date to another is the difference between the changes in the amounts of its assets and liabilities. Conceptually this is a broader definition of income.

In terms of the narrow definition, inflation affects the distribution of income only to the degree that it alters the way that the flow of total income is distributed by income class. If this remains unchanged despite inflation, then by definition inflation does not affect distribution of income.

However, by the broad definition, inflation may leave the flow covered by the narrow definition unchanged, but still significantly alter the distribution of income by causing changes in the distribution of net worth of household by income class.

The effects of inflation on redistribution of income can be understood by knowing the effect of inflation on different group of societies which are as follows:

(i) *Debtor and Creditors:* During inflation, debtors return the same amount of money, but they pay less in terms of goods and services. Thus, the burden of the debt is reduced and debtors gain. On the other hand, creditors lose because they receive less in real. Thus, inflation brings about a redistribution of real wealth in favor debtors.

(ii) *Salaried Class:* During rising prices, salaried persons lose because their salaries are slow to adjust when prices are rising.

(iii) *Fixed Income Class*: The recipients of transfer payments such as pensions, unemployment insurance, social security, etc. and recipients of interest and rent live on fixed incomes. All such persons lose because they receive fixed payments, while the value of money continues to fall with rising prices.

(iv) *Investors*: There are two types of investors first, who invest in shares or stocks of companies and second who invest in fixed interest bearing bonds. Investors of first group gain because when prices are rising, business activities expand which increase profit of companies. As profits increase, dividends on equities also increase at a faster rate than prices. But investor of second type loses during inflation because they receive a fixes sum while the purchasing power
is declining.

(v) *Farmer:* Landlord loses during rising prices because they get fixed rents. But peasant proprietors who own and cultivate their farm gain. The landless agricultural workers are hit hard by rising prices.

(B)The Effects of inflation on Output, Employment and the Growth Rate

For an economy producing below potential, many economists maintain that inflation of the creeping or crawling variety will have a tonic effect on output and employment. In the event of unanticipated inflation, prices rise faster than money wage rates, and the resulting reduction in the real wage rate gives business the profit incentive to hire more workers and expand output. Consequently, a rise in the inflation rate, if unanticipated, may lead to a reduction in the unemployment rate, given an inflation in which wages lag behind prices, the wage share of total income shrinks and the fraction of total income saved expands. This follows the fact that a larger portion of the total income goes to profits and other non-wage income, the recipients of which are typically upper income groups with a relatively high propensity to save. That a greater saving will occur under the conditions her specified is well established. When one compares the rate of inflation and the rate of growth of real gross national product in major industrialized countries over the period since World War II, one finds no clear pattern. West Germany (with the lowest rate of inflation) has shown one of the highest rates of growth and Japan (with a high rate of inflation) has shown by for the higher rate of growth. The U.K. (with the lower rates of growth) is among the highest in terms of the rate of inflation. These are problems of interpretation here due to the impact of World War II.

(C) *Other Effects of Inflation*

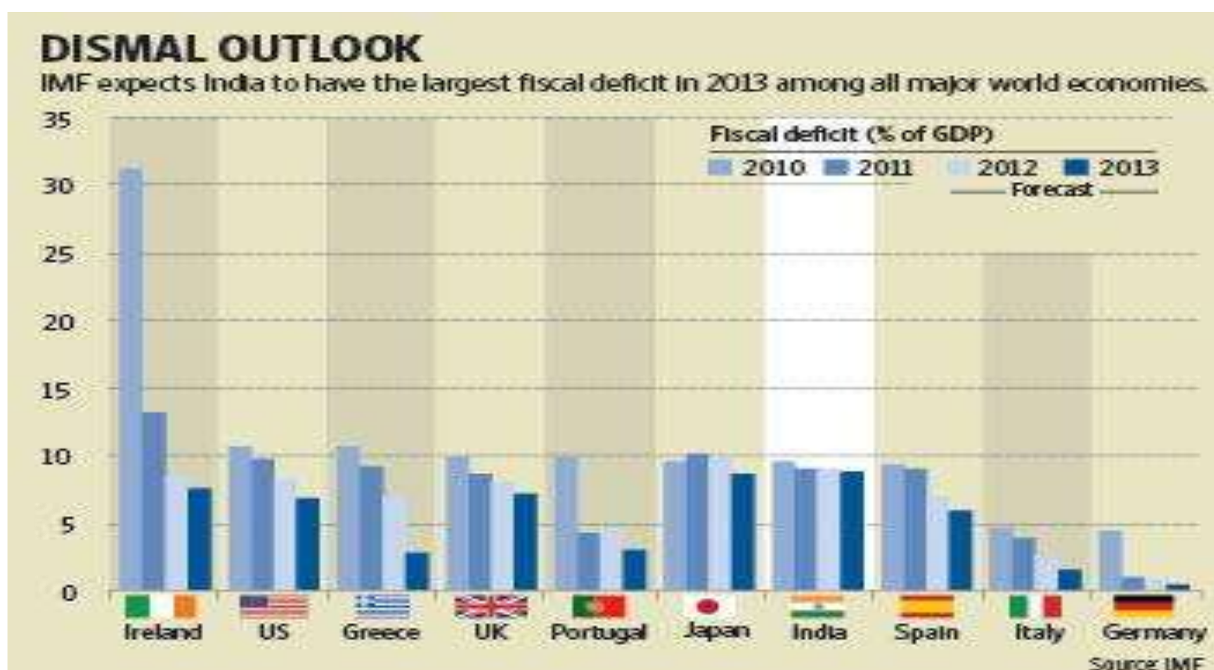
Inflation leads to a number of other effects which are discussed as under

(i) *Government:* The government gains under inflation for rising wages and profits spread as illusion of prosperity with in the country.

(ii) *Balance of Payments:* During inflation, domestic become costlier compared to foreign products. This leads to increase imports and reduce exports, thereby making the balance of payments unfavorable for the country.

Fiscal deficit

Fiscal deficit is the difference between the government's total expenditures and its revenues (excluding money from borrowings). A country's fiscal deficit is usually communicated as a percentage of its gross domestic product (GDP).



Source:www.equitymaster.com

Causes of fiscal deficit

Some of the causes of fiscal deficit are as follows:

1) *Payment of Interest:* One of the main causes of fiscal deficit is the interest paid by the government on both the domestic and foreign loans. According to Trading Economics Indian government's debt to GDP ratio has been forecasted to 67.53% for the calendar year 2013. This has resulted in increased interest burden on the government.

2) *Increase in subsidies*: Subsidies directly increase the fiscal deficit. Therefore, the subsidies provided by the government in various consumables like oil, gas, food etc. directly increases the fiscal deficit.

3) *Defence Budget:* the defence budget has also seen an upward trajectory in recent years due to the security concerns for Indian borders and the government has a very limited possibility to reduce it. Hence, defence expenditure also increases the fiscal deficit.

Consequences of High Fiscal Deficit in India

A high fiscal deficit is an indicator that the economy is in trouble. A high fiscal deficit may lead to inflation in the economy and may also increase interest rates. It also degrades the country's credit rating which in turn will discourage the foreign investments in India. The government may borrow additional money from both internal and external sources to solve the fiscal deficit which in turn puts more pressure on the government as they have to pay more interests on loans.

A high fiscal deficit may also stop the government from increasing expenditure in education, healthcare, infrastructure or welfare policies.

According to government data, India's fiscal deficit during the period of April-July, 2013 was Rs. 3.41 lakh crore and has reached 62.8% of the full-year target set by the government.

Growing figures of fiscal deficit is definitely a challenge to the Indian economy. It's time that the government takes the bull by the horns to reduce the fiscal deficit. They should bring policies to galvanize foreign investments in India, rethink on the provision of subsidies, widen the tax net etc.

Rupee depreciation

Depreciation refers to a fall in the value of the domestic currency which is caused by the demand for foreign currency exceeding its supply in the market. In such a situation one has to pay more than before to get units of foreign currency. This fall takes place in the market and on its own. Market determined exchange rate serves the purpose of aligning the domestic economy with the world economy was the price route. As consequences the domestic price gets linked up with those of the world price. With the liberalizations and globalization of the economy in recent years, imports are bound to increase. The lessening of restrictions on imports and lowering of tariff on imports which the economic reform

implies, an increase in imports has in fact taken place. Again with trade having become an important element of the new strategy of growth.

Strong demand of US currency from importers and banks, continuous capital outflows, widening current account deficit and dollar's strength against other currencies overseas amid expectation that the Federal Reserve will soon taper its bond-buying programmes has put pressure on the rupee how continuous depreciation of the Indian currency will affect the common man.

Importers/Exporters

Importers will strongly feel the pinch of falling rupee as they will be forced to pay more rupees on importing products. Conversely, a feeble rupee will bring delight to the exporters as goods exported abroad will fetch dollars which in return will translate into more rupees. Also, a weak rupee will make Indian produce more competitive in global markets which will be fruitful for India's exports.

Imported goods: Buying imported stuff will become a very costly affair. You will have to shell out extra on imported goods. For instance if you bought a product valued USD 1, you paid around Rs 54 (months ago) but you will now have to shell out close to Rs 68 for the same product.

Fuel price: A weak rupee will increase the burden of Oil Marketing Companies (OMCs) and this will surely be passed on to the consumers as the companies are allowed to do so following deregulation of petrol and partial deregulation of diesel. If the OMCs increase fuel prices, there will be a substantial increase in overall cost of transportation which will stoke up inflation.

RBI’s monetary policy: If the depreciation in rupee continues, it will further increase inflation. In such a situation RBI will have very less room to cut policy rates. No cut in policy rate will add to the borrower’s woes who are eagerly waiting to get rid of the high loan regime.

Students studying abroad: Students who are studying abroad will bear the brunt most owing to depreciating rupee. Expenses incurred towards the university/college fee as well as that of living will shoot up, thereby spelling a huge burden on the students.

Tourism: The depreciating rupee will surely be a dampener if you are planning your holiday abroad. Your travel charges as well as hotel charges will escalate drastically, let alone shopping and other miscellaneous spending activity.

Overseas Indians: Money saved is money earned. Depreciation of rupee is certainly a good news for the overseas Indians. Those working abroad can gain more on remitting money to their homeland.

Country’s fiscal health: A frail rupee will add fuel to the rising import bill of the country and thereby

increasing its current account deficit (CAD). A widening CAD is bound to pose a threat to the growth of overall economy.

Stalled Reforms

The momentum of the economic liberalization process - that began with the dismantlement of the infamous License Raj, which lowered trade barriers and liberalized the foreign investment regime during the government of prime minister P V Narasimha Rao in 1991 in the face of a foreign exchange crisis - appears to have slowed under the current Congress government that came to power in 2004.Despite the presence of a prolific private sector, high savings rate and large and growing domestic market, economic exuberance is not sustainable in the absence of several fundamental reforms. These include the fact that the country still remains a largely agrarian economy held hostage to annual rainfall in the absence of much-needed investment in irrigation infrastructure.

Policy priorities for the Indian economy were divided as near term and medium term. Near term will include increase in petroleum and fertilizer prices ; moderation of entitlement programmes ; resurrecting reforms, which includes FDI in retail, fast-tracking 'Goods and Services' Tax ; pushing through impending laws on banking, insurance and pension ; and restoring investor confidence. Revamping of energy policies, reforming land, water, natural resource allocation, flexible labor laws, better human skill development and accommodating the challenge of urbanization form the medium term measures.

Several crucial bills on issues ranging from DTC (direct tax code), to GST (goods and services tax) and corporate governance remain stalled in parliament

FDI in Insurance and Pension Sectors

India has plans to permit 26 percent FDI in the pension sector and raise the investment limit in the insurance sector to 49 percent from 26 percent. However, political opposition has forced the government to defer the proposals as enacting them requires legislative approval.

The ruling coalition does not enjoy the required majority in the upper house of parliament to pass the proposals.

Goods and Services Tax (GST)

The proposed reform intends to transform India into a single fiscal union, helping cut business costs and boost government revenue. A nationwide GST is estimated to add between 0.9-1.7 percentage points to India's GDP.

However the proposal, first mooted in 2007, is facing opposition from state governments, which fear revenue losses once the GST comes into effect. Enacting GST requires an amendment to the constitution, which needs approval by two-thirds of federal lawmakers and needs to be passed by at least half of 28 state legislatures.

The fifth and last challenge is to the boost manufacturing sector: Being a primarily services driven economy, the share of manufacturing has been stagnant at a mere 16 percent of total GDP. India’s Asian peers, such as China, South Korea and Taiwan, have immensely benefited from a strong manufacturing sector, which enables greater employment creation, attracts higher and stable foreign direct investment and bolsters infrastructure development. However, bottlenecks in land acquisition, archaic labor laws, poor physical infrastructure, less favorable tax rules and tight regulations deter manufacturing sector growth in India. Reassuringly, the Indian government has approved a national manufacturing policy aimed to increase the manufacturing’s share in GDP from the current 16 to 22 percent in a decade and in turn create millions of jobs and add capacity to sustain the pace of economic growth. That said, effective implementation of such policy drive will clearly prove difficult given past records.

Suggestions

- Speed up Aadhar pilots; use study results to shift to direct transfer of subsidies across India
- Scrap diesel & urea subsidies, decontrol diesel
- Controlling fiscal deficit will curtail current account deficit
- Restore distribution margins on financial saving products, to curb demand for gold
- Overseas bonds are an option Clear FDI decisions quickly
- *Liberalize financial markets:* India needs huge amounts of domestic and foreign capital to achieve its potential -- and a better-functioning capital market to allocate it wisely
- Introduce a medium to long-term fiscal-policy framework,a deficit of less than 3 percent of GDP and debt of less than 60 percent of GDP.
- Adopt an inflation target, and make it the center of a new macroeconomic policy framework.

- *Improve governance-* This is probably the hardest and most important task -- the precondition for the rest.
- *Encourage manufacturing-* Manufacturing must be encouraged in power, steel, metal, automobiles, electronic hardware and textiles, India was currently importing items that could easily be manufactured in the country.

References

1. Macro Scan, “Controlling Food Price Inflation,” Business Line, 23 February 2010
2. Fisher,Stanley(1993) The Role of Macroeconomic Factors in Growth, Journal of Monetary
3. Economics, pp 485-512
4. Uma Kapila, *Indian Economy since Independence,* New Delhi: Academic Foundation, 1998
5. http://in.reuters.com
6. http://zeenews.india.com
7. http://www.deccanherald.com
8. http://southasiamonitor.org
9. http://www.atimes.com
10. http://www.quantumamc.com
11. http://www.bloomberg.com
12. http://www.emeraldinsight.com
13. http://articles.economictimes.indiatimes.com
14. http://www.economicshelp.org
15. http://www.worldpolicy.org
16. http://www.rediff.com
17. http://www.caclubindia.com