A Response

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Y V Reddy's central point is that while outlining a strategy for the Twelfth Plan, we must also focus on the risks that the economy may face and evolve a strategy to manage those risks. This is sage advice and a very useful input as we move towards finalising a workable strategy for the Twelfth Plan.

The Plan will face different types of risks. Some are external in origin and we can do little to minimise them. We can only work to manage them if they arise. Others are a consequence of the strategy we adopt and can arise for two reasons. First, there is always uncertainty about how an economy will respond to the changes we try to orchestrate, and if things do not work out quite as we planned, because we miscalculated the nature of the response, or some of the responses take longer to materialise, there may be unforeseen outcomes that may be unfavourable for some groups. Second, we may not be able to implement some of the things we have identified as part of the strategy and this creates an unbalanced strategy which could have unexpected poor outcomes.

Responding to Risks

How should we respond to these possibilities? These risks present interesting choices. We can consciously choose a strategy which entails a lower level of risk and therefore possibly lower reward, thus reducing risk ex ante at some cost to growth, or we can aim at a high reward strategy combined with conscious measures of risk management, to be able to deal with unfavourable outcomes should they arise. Sensible planning will probably involve a balance between these two alternatives, and the balance is likely to vary from sector to sector. For example, we can all agree that we should be very cautious in making changes in the financial system, because a mistake here can have systemic consequences. We can be more willing to experiment in the real sector, where risks can be more easily managed and mistakes can be spotted more easily, and also reversed or otherwise dealt with.

The external risks mentioned by Reddy – pressure of rising commodity prices on inflation, the impact of sovereign debt crises in industrialised countries on the availability of capital for emerging markets and the possible volatility in capital flows

to emerging market countries – are all relevant, as acknowledged in my paper. Specific strategies for dealing with risks will have to be evolved, consistent with the basic strategy adopted. There is an interdependence between the strategy chosen and the level of risk. For example, if we adopt the strategy recommended in the paper of aiming at higher levels of investment in infrastructure, and this forces us to accept a somewhat higher current account deficit of up to 3% of GDP, we have to depend more on capital inflows. It follows that we will be that much more vulnerable to a volatility of capital flows.

This poses the choice outlined above. We could opt for a safer strategy ab initio, by setting a lower level for the permissible current account deficit, say between 2 and 2.5% of GDP, and therefore accept a lower rate of investment and growth. I argue that a 3% current account deficit is acceptable if it can be funded by long-term capital flows, especially foreign direct investment (FDI). But this does involve the risk of temporary disruption because of volatility of capital flows. Fortunately, the size of our reserves provides fairly high assurance that we can manage a temporary disruption, provided the underlying macroeconomics remain favourable and policies are seen to be investor-friendly. How to ensure that the conditions spelt out in the proviso are achieved is, of course, a major challenge.

I should clarify that in referring to a target of $1 trillion for investment in infrastructure, my paper may have given the impression that these investments would be entirely funded by foreign debt and equity. That would certainly involve excessive exposure. The dollar figure was used simply because it has been used in many public statements, some of which were addressed to international audiences. There should be no doubt that in practice most of the infrastructure funding in the Twelfth Plan would have to be based on domestic resources.

As the Plan is finalised, the Planning Commission will work out a breakdown of this infrastructure investment between the central, state and private sectors. The central and state components may have some foreign borrowing component and the private sector could have some combination of foreign equity and foreign debt. However, the foreign component of infrastructure financing will have to be accommodated within the projected tolerable current account deficit, which, as indicated in the paper, could at most be pushed to 3% of GDP. The total net inflow on this basis over the Twelfth Plan period cannot exceed $275 billion, and since all of it cannot be directed to infrastructure, it follows that the investment target for infrastructure has to be met dominantly by domestic financing. The feasibility of achieving this outcome depends critically on the projected improvement in the fiscal deficit. Y V Reddy rightly emphasises that there is a risk that the fiscal objective may not be achieved. I agree that this risk and its implications must be carefully considered.

Planning has often been caricatured as the "triumph of hope over experience". There is even some merit in planning on the basis of positive expectations about what we can achieve. However, since fiscal slippage will have a severely disruptive effect on the economy's macroeconomic credibility and growth potential, I agree that we should plan for slippages in this area. We should perhaps specify in advance what parts of the Plan will need to be adjusted if significant slippage occurs, so that the adjustment can be made in the least disruptive manner. This will invariably imply lower levels of productive investment, lower growth of both GDP and employment, possibly higher inflation, and also slower expansion in programmes of inclusiveness.

Financial Sector

As pointed out above, we need to be cautious on financial sector reforms, as we have been thus far, moving forward in a gradual manner. The point which I emphasise in the paper is that the forward movement should continue. The financial crisis has actually endorsed our strategy and it should not lead to abandonment of that strategy. We have quite some way to go to develop the financial system that we need to realise our full growth potential.

Y V Reddy has identified several specific risks and they all deserve careful consideration. More generally, the entire Plan strategy should be subjected to serious risk assessment by analysing what key assumptions about the underlying structure of the economy, or about our ability to implement policy changes, could turn to be different. Based on this analysis, major downside possibilities should be identified and contingency plans developed to deal with them. This is easier said than done, but I do agree that more needs to be done in this area. The more recent techniques of scenario painting are perhaps relevant.

One requirement of sensitivity to risk is constant watchfulness for unintended consequences. The effectiveness of policy needs to be subjected to independent evidence-based evaluation. The Planning Commission is strengthening its capability in this area by establishing an Independent Evaluation Office.

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