Prospects and Policy Challenges in the Twelfth Plan: A Comment on the Risks

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The article "Prospects and Policy Challenges in the Twelfth Plan" by Montek S Ahluwalia (EPW, 21 May 2011) offers a comprehensive overview of the subject, but what is missing is a discussion of the risks to the economy. An enumeration and discussion of the many risks that must be taken into account while framing the Twelfth Plan.
In the second article the author responds to these comments.

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Montek S Ahluwalia's article, "Prospects and Policy Challenges in the Twelfth Plan" (EPW, 21 May 2011) provides a comprehensive, succinct and summary overview of the subject and is very useful as reference material. There is, however, a vital element that is missing in the analysis, namely, a discussion of the risks to the economy and economic agents. Experience shows that at high levels of economic growth there is vulnerability to shocks. The recent developments in the global economy are indicative of uncertainties in the outlook for the medium term and the volatilities in global commodity and financial markets. A growth strategy and a medium-term plan that explicitly recognises and analyses such risks may provide comfort and confidence in the plan. The comments in this note are meant to invite the attention of planners to some of the obvious risks that warrant an assessment and design of mitigation strategies or contingent plans.

Inflation Risk

First, the inflation risk on account of global developments could be severe on India, since we are already witnessing severe inflationary pressures domestically. There is an increasing recognition among experts in monetary policy that inflation targets in the future could be higher than before, partly to provide headroom for countercyclical policies and partly for accommodating huge public debts in the advanced economies.

Second, the allocation of global financial capital in the future will be very different from the past, since the demands of the public debt of the advanced economies will be larger. In other words, the allocation of global capital between debt and equity, between the advanced and emerging economies, and between the public and private sector, may be governed by what may be termed as the "new realities". India is particularly vulnerable relative to most other countries in Asia since apart from current account deficits, the quality of the stock of external liabilities has changed towards more volatile portfolio flows and short-term debt, in addition to non-greenfield foreign direct investment (FDI). The vulnerability to external shock has significantly increased since the deterioration of the external situation in recent years has been accompanied by a similar trend in the fiscal arena.

Third, the policies for better agricultural performance have to recognise the risks faced by the farmers, especially as they move away from cereal cultivation to more commercialised agriculture. The main source of risk is in the public sector, in the delivery of water and power, which are critical inputs. Another source of risk is the lack of effective regulation of the quality of inputs like fertilisers and seeds. Yet another source of uncertainty is the policy of the government on trade within the country and export/import.

Fourth, on infrastructure development, the investment requirements in the article are indicated in US dollar terms at $ one trillion over the Twelfth Plan period. The significance of expressing the needs in US dollar terms is not clear, and the amount will be equal to a lion's share of the total current account deficit during the Plan period as a whole. If the intention is that such investments will be funded by external flows and that too of a long-term nature, broader issues of sustainability of external debt would arise. In almost all public-private partnerships in infrastructure, there is, directly or indirectly, a contingent liability on government, as would be evident from the terms of the contracts. So the quasi-sovereign nature of these debt obligations in external account may add to risk.

Risk of Financial Instability

Fifth, there may be merit in recognising that financial instability may not be entirely behind us, but it could very well reappear soon within the Twelfth Plan period. In the light of evolving debates, there are several risks in proceeding with

what may be termed as traditional wisdom (assertions?) relating to the optimal financial sector. This can be illustrated with some examples given in the article. There is a reference to the creation of the Public Debt Management Office, but a strong case is now being made to restore public debt management to central banks even in the advanced economies. Let me quote a respected authority:

> When markets get difficult – and government bond markets are likely to do so – the need is to combine an overall fiscal strategy with high-calibre market tactics. The latter is what central banks have as their métier. During that coming epoch of central banking, they should be encouraged to revert to their role of managing the national debt
> (C A E Goodhart "The Changing Role of Central Banks", BIS Working Paper No 326: November 2010).

There is a reference to the size of Indian banks as another issue. While the large size of banks may be useful in enhancing shareholder values, their contribution to efficient allocation of resources is suspect while their potential for causing systemic instability is significant. The well-known Volcker Rule has generally been given some weight in debates on financial sector reform in the US. The strict application of such a rule may be inconsistent with the encouragement of the growth of large banks. A more recent report of the John Vickers Commission in the United Kingdom echoes similar views. Viable banks may have to be differentiated from large-sized banks, and large-sized banks should be differentiated from the "too big to fail" or even the "too powerful to regulate" banks. More generally, there is merit in closely monitoring the ongoing debates on the appropriate framework for an efficient and stable financial system rather than assuming that while we need to avoid the excesses of Anglo-Saxon model, we must proceed on the reform front broadly with the framework that has been designed, pursued and advanced by the international financial centres.

The importance of policies to manage volatility in capital flows has come to the fore in recent debates. With India's projected current account deficit and the nature of stock of external liabilities, risks arising out of such volatility and the need for appropriate policies to manage such risks, especially in the capital account and financial sector become critical for us.

Finally, the growth of capital to reach an average savings rate of 37% of GDP is based on the assumption of an improvement in fiscal conditions. The section on "Financing the Plan with Macro-economic Balance" rightly focuses on the quantitative and qualitative aspects of fiscal adjustment. However, the consequences of fiscal slippage should be assessed, since a slippage has implications not only for financing the Plan but also for macroeconomic and financial stability. The current policy of financial repression is key to managing our public debt without threatening stability. If reforms in the financial sector are undertaken on unrealistic assumptions of robust and sustained fiscal consolidation, any fiscal slippage is likely to induce instability, both in the financial and external sectors. The risks of premature reforms in terms of deregulation of the financial sector and liberalisation of the capital account, especially in relation to debt markets, relative to assured fiscal consolidation, should not be underestimated. The experience with the global financial crisis in regard to the sovereign debt of even advanced economies is too bitter to be ignored.

Above all, India has many, very many, poor people whose capacity to assume or manage risk is extremely limited. The strategies for inclusive growth should, therefore, analyse and account for both macro and micro risks. This would enhance the value of the approaches that have been very well articulated in the article.