

# Challenges, Policy Response and Medium-term Prospects

## 2

### CHAPTER

*During the last two years, the Indian economy has been buffeted by three major challenges originating in its external sector. First, a surge in capital inflows, which reached a crescendo in the last quarter of 2007-08. Second, an inflationary explosion in global commodity prices, which began even before the first challenge had ebbed, that hit us with great force in the middle of 2008. There was barely any time to deal with this problem before the third challenge, the global financial meltdown and collapse of international trade, hit the world with severity. Despite some difficult choices and ambiguities, arising from the rapid changes in the global situation, the short-term challenges arising from these global shocks have been met. Each of these, however, has implications for the medium term, that requires a considered and integrated response if our objective of sustained high growth is to be realized. An analysis of the impact of these shocks brings to the fore the importance of pursuing reforms, including in the financial sector, to make the economy more competitive and the economic regulatory and oversight system more efficient and sensitive to new developments.*

2.2 The Economic Survey of 2007-08 (February 2008) had pointed out that “There is now no doubt that the economy has moved to a higher growth plane, with growth in GDP at market prices exceeding 8 per cent in every year since 2003-04.” It had however warned that “The new challenge is to maintain growth at these levels, not to speak of raising it further to double digit levels.” Further, “The challenges of high growth have become more complex because of increased globalization of the world economy and the growing influence of global developments, economic as well as non-economic.” Ten months later, the Mid-Year Review (December 2008), noted that “We should be prepared for growth in 2008-09 as a whole to be around 7 per cent.” The experience of economic growth in a wide range of countries across the world and over different periods of history bears testimony to the fact that such setbacks are common. The experience of high growth economies (HGEs) suggests that these can be overcome by appropriate, pragmatic (non-ideological) and expeditious action to address the

problems that the shocks expose and by seizing the opportunities that they open up. This is what distinguishes the few economies that sustain growth over decades (by returning to high growth after a temporary setback) from the many that fall by the wayside (returning to slower growth after a temporary spurt of high growth).

2.3 The challenges that confronted the Indian economy in 2008-09 and continue to do so in 2009-10 fall into two parts. The short-term macro-economic challenges of monetary and fiscal policy and the medium-term challenge of returning to the high growth path. The former covers issues such as the trade-off between inflation and growth, the use of monetary policy versus use of fiscal policy, their relative effectiveness and coordination between the two. The latter includes the tension between short- and long-term fiscal policy, the immediate longer term imperatives of monetary policy and the policy and institutional reforms necessary for restoring high growth. This chapter reflects on some aspects of these issues.