Indian Public Policy Review 2024, 5(2): 01-18
https://doi.org/10.55763/ippr.2024.05.02.001

IPPR

Similarities yet Divergence in South Asian Macroeconomic Performance

Ashima Goyal[*#]

Abstract

Stylized business cycle facts for South Asia are both similar and different from other regions. They show the dominance of supply shocks, often amplified by macroeconomic policies and procyclical current accounts. Interest and exchange rate volatility rose initially on liberalization, but fell as markets deepened. A gradual approach to openness and market development, with flexible exchange rates, that avoided complete liberalization, worked well initially. But a combination of excessive government/foreign borrowing and inadequate reserves made it difficult for smaller countries to withstand the multiple external shocks that began with the global pandemic. Domestic ability to smooth shocks and global safety nets are both essential. India benefitted from growing diversity, evolution to countercyclical macroeconomic policy better suited to structure and a good coordination of monetary and fiscal policies, with balance between demand stimulus and continuing supply-side reforms. Reserves and capital flow management policies helped insulate from global shocks. Intervention damped excess exchange rate volatility, reducing risk premiums.

Keywords: South Asia, Supply shocks, Flexible exchange rates, Diversity, Smoothing

JEL Codes: E3, E63, O11

Publication Date: 15 April 2024

* Ashima Goyal is an Emeritus Professor at Indira Gandhi Institute of Development Research.

This is revised and updated version of a chapter published in Routledge Handbook on South Asian Economies 2011. I thank Garry Pursell and Raghbendra Jha (editor) for comments, Sanchit Arora, Shruti Tripathi and Sritama Ray for excellent research and Reshma Aguiar and Shreeja Joy Velu for prompt secretarial assistance.

1. Introduction

We review the macroeconomic performance in South Asian (SA) countries, and analyze why despite opening out at a time after which major international shocks occurred, they did reasonably well until the global financial crisis (GFC). A gradual approach that combined opening with domestic market development, while avoiding full liberalization, worked well initially. Flexible exchange rate regimes prevented overshooting and persistent misalignment. The exchange rate had to be competitive, since the region had a current account deficit. Fiscal deficits were also higher than East Asian peers.

In contrast, in 20th century Latin America, fiscal profligacy had resulted in repeated macroeconomic crises despite a variety of macro stabilization efforts. The East Asian crises of the 1990s occurred despite a fiscal surplus, because of too rapid financial liberalization, combined with policies such as fixed exchange rates that created moral hazard.

We build a set of business cycle stylized facts that identify unique features of the SA region and derive implications of structure for policy. Macroeconomic policies and procyclical current accounts often amplified dominant supply shocks. Interest and exchange rate volatility rose initially on liberalization, but fell as markets deepened.

Growth was lower for all emerging markets (EMs) under global risk-on and risk-off, following the GFC. Reserves of smaller SA countries proved inadequate under rising government and external debt and the series of external shocks following the global pandemic. Domestic ability to smooth shocks and global safety nets are both essential.

India benefitted from growing diversity, evolution to countercyclical macroeconomic policy better suited to structure, and a good coordination of monetary and fiscal policies, with balance between demand stimulus and continuing supply-side reforms. Reserves and capital flow management policies helped insulate from global shocks. Intervention damped excess exchange rate volatility, reducing risk premiums.

Similar features led to convergence in macroeconomic policies in the region – but differing political systems reduced buffers required for smoothing external shocks, causing divergence.

The remainder of the paper is structured as follows. Section 2 builds stylized facts for the region. Business cycle correlations obtained in 2.1 are used to derive an analytical framework consistent with the correlations and analyse the impact of shocks in 2.2, including shocks from openness in 2.3. Section 3 extracts patterns from a data-based comparison of macroeconomic outcomes and volatilities over the years. Section 4 turns to a narrative history of macroeconomic policies in India, first drawing out the impact of structure and shocks (4.1) and political changes (4.2) on them before analysis of the policies themselves in 4.3, debt and fiscal reform in 4.4 and monetary-fiscal coordination in 4.5. Section 5 concludes.

2. Stylized facts

2.1 Business cycle correlations

Insights from optimizing behaviour for emerging market (EM) macroeconomic cycles in the literature include Calvo and Vegh (1999), who explain the surge in Latin American consumption expenditure following exchange rate stabilization by the poor credibility of the stabilization and its expected reversal. Aguiar and Gopinath (2007) find more volatile trend growth, driven by policy instability, makes EM optimal consumption more volatile, and the current account (CA) strongly counter-cyclical. Net exports (NX) fall as output, consumption, and imports rise. If the trend is the cycle for EMs, or shocks are regarded as permanent, optimal consumption should vary more than output as expected future income also rises. In mature markets the trend is stable, so consumption is smooth.

Aguiar and Gopinath (2007) derive business cycle characteristics—volatility through the standard deviation (σ) and autocorrelation (ρ)—or degree of co-movement in time series of macroeconomic variables. Their average values for 13 EMs, excluding SA economies, and 13 developed markets are reported in the last two columns of Table 1.

We find patterns differ for SA economies when we calculate yearly time series moments[1] (quarterly data are not available). So the table compares yearly to quarterly moments. But since they were worried about measurement errors in EM quarterly data, Aguiar and Gopinath also calculated unreported yearly moments, with similar results. They restrict their data to the 1980s and '90s (patterns were different in the 1960s and '70s, when the EMs were largely closed.)

We restrict our data set to the post-liberalization era in the SA region – calendar years 1980-2007 – to avoid the atypical post-GFC shocks. Since this populous region is a source of many migrants, remittances are important. So we also investigate the cyclicality of the current account (CA). The patterns Table 1 reveals are:

1. Output (Y) volatility is relatively much higher in SA.
2. Volatility of C/I, I/Y, is much lower, implying a much higher volatility of consumption (C) and investment (I) that matches output volatility.
3. Volatility of growth rate, or log difference of output, is higher.
4. Correlation of C and I with Y is much higher: Close to 1 compared to 0.7 for other country groups.
5. Correlation of Y, Y_{-1} is higher; implying greater persistence of shocks, but that of growth rates is erratic, varying from high positive to negative. The growth correlation for India and Sri Lanka is close to that for the EM group.
6. Volatility of NX/Y is lower in India, Bangladesh, and Nepal, but higher for the others.

7. Correlation of NX/Y with Y is high positive, compared to high negative for the EM group and low negative for developed countries; that is, it is procyclical in SA[2]. Correlation of CA/Y with Y is uniformly high and procyclical.

Table 1: South Asian volatilities compared to other emerging and developed markets

	India	Pakistan	Sri Lanka	Bangladesh	Nepal	Bhutan	Emerging Markets	Developed Markets
$\sigma(Y)$	16.94	21.38	25.34	33.10	45.13	39.46	2.74	1.34
$\sigma(\Delta Y)$	3.20	2.93	2.33	1.23	2.45	1.57	1.87	0.95
$\rho(Y_t, Y_{t-1})$	0.9981	0.9991	0.9987	0.9999	0.9996	0.9999	0.76	0.75
$\rho(\Delta Y_t, \Delta Y_{t-1})$	0.27	-0.10	0.21	0.57	0.61	-0.08	0.23	0.09
$\sigma(C)/\sigma(Y)$	1	0.97	0.92	1.09	0.995	0.85	1.45	0.94
$\sigma(I)/\sigma(Y)$	1.59	1.02	0.98	1.59	1.07	1.06	3.91	3.41
σ (NX/Y)	0.72	3.46	3.32	0.43	1.55	7.96	3.22	1.02
σ (CA/Y)	0.77	2.24	2.87	6.97	0.10			
ρ (NX/Y,Y)	0.14	0.65	0.70	0.25	-0.84	0.80	-0.51	-0.17
ρ (CA/Y,Y)	0.69	0.20	0.79	0.85	0.85			
ρ (C,Y)	1	0.996	0.9999	0.998	0.9998	0.99	0.72	0.66
ρ (I,Y)	0.99	0.99	0.99	0.996	0.998	0.998	0.77	0.67

Note: The last two columns list average values of standard deviations in percentages and correlations using quarterly data for 13 developed economies and 13 emerging economies, excluding South Asia. (Source: Aguiar and Gopinath 2007). The moments for South Asian countries use annual data. All variables are HP-filtered, except growth rates (first differences of logs).

Implications from these stylized facts are:

1. Higher volatility of Y, C, I, and growth: More shocks and less ability to smooth shocks.

2. Higher C, I correlation with Y; less volatile C, I ratios: Less-developed financial markets or less wealth may be limiting C to income. Or shocks are regarded as temporary, so rather than borrowing for C, savings rise. The important point is higher C, I volatility does not drive income volatility, but follows it. Since C and I are not the source of high observed income volatility, shocks must be primarily to supply, or external, and induced demand multiplication must be coming largely from policy.

3. NX procyclical: Procyclicality can occur in two ways. First, if growth is export driven, NX would rise with output. Second, the region is dependent on oil imports. An oil price shock is deflationary, reducing output but also raising the import bill, implying NX would fall with output. If imports rise in booms the NX would be countercyclical, but if the international oil price effect dominates, imports would rise in slowdowns. The global cycle and NX is then a source of shocks. Since policy influences the CA, policy that magnifies shocks could make NX more procyclical. Remittances that rise with oil prices, and other types of economic diversity, moderate the cyclicality of the CA.

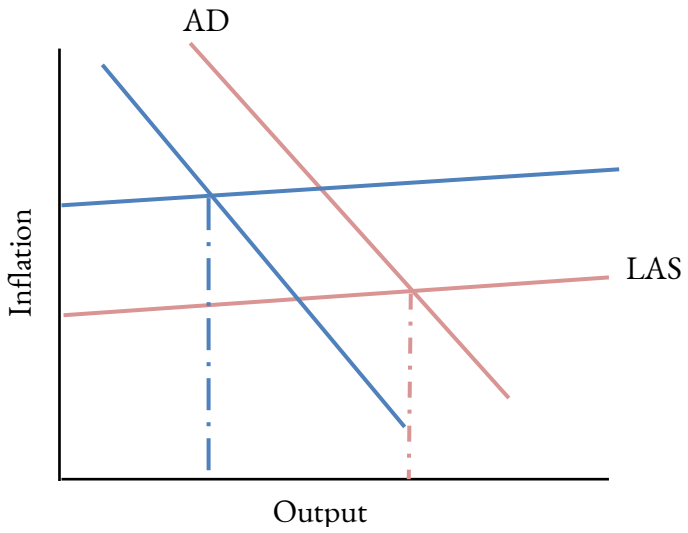
4. Correlation of Y, Y_{-1} higher; correlation of Y, growth low: More frequent as well as persistent shocks with less policy smoothing would explain this.

These patterns point to inadequate public and private ability to smooth shocks. Persistent shocks may partly be due to this inability. Supply side shocks are to be expected in oil importer economies that are still agriculture dependent, have constrained markets, and have severe infrastructural and other bottlenecks.

2.2 Structure and shocks

A simple analytical framework consistent with these stylized facts is developed and used to examine the effect of shocks and openness. During a catch-up period of high growth, as a large labour force shifts to more productive occupations, longer-run aggregate supply (LAS) is elastic (Figure 1), but frequent adverse supply shocks push it upwards. Cost shocks and inflationary expectations raise prices over all current output ranges, rather than only at full employment. If labour mobility is high, this provides a better framework of analysis compared to traditional two-sector dual economy models. The LAS becomes vertical only as the economy matures and full productive employment is reached.

Figure 1: Aggregate demand and supply



In India, monsoon failures or international oil price shocks have been dominant inflation triggers. Propagation mechanisms such as governance failures convert these into low chronic cost-push inflation (Goyal 2012). For example, political pressures from farmers push up farm support prices, with consumption subsidies also going up. But these are inadequate due to corruption and failures of targeting[3]. Since food has a large share in the consumption basket, nominal wages rise with a lag, pushing up costs and generating second-round inflation from a temporary supply shock. Political support also raises wages through minimum wages and employment schemes[4]. If monetary tightening

pushes the demand curve leftwards along a flat supply curve, the cost in output sacrifice is high, with little impact on inflation. It is the upward creep in the supply curve that affects the latter. But as fiscal populism increases demand, money supply is often tightened as an offset.

Such a framework would explain high and persistent output volatilities, as policy choices aggravate output contractions in response to frequent supply shocks. The procyclical CA is the result of one of these frequent shocks—international oil price fluctuations.

Empirical tests support the elastic long-run supply and the dominance of supply shocks. They demonstrate endogenous amplification of supply shocks, with further upward shifts, through reductions in demand during growth slowdowns (Goyal, 2015). Results generalize to SA countries that share the crucial feature of high productivity growth releasing labor, thus allowing an elastic supply response.

But strategies to fight inflation can be designed within this structure. A cost shock creates a short-run tradeoff between inflation and output variability. Instead of relying solely on monetary tightening to bring down inflation, more nuanced policies that shift down the supply curve are feasible. For example, exchange rate appreciation, or fiscal measures such as tax-tariff rates and freer imports. Early tightening towards a positive real rate (signaling further response as required) can anchor inflationary expectations, and prevent the second-round wage-price spiral without a sharp demand contraction. Greater interest and exchange rate flexibility make more monetary policy options available.

The labour market structure implies output is below potential. If food prices are stable, capital is available, specific bottlenecks are alleviated, and institutional reforms undertaken, supply is not a constraint on output.

2.3 Openness

Openness after liberalizing reforms led to a rise (and fluctuations) in capital flows, which were a new source of shocks. But sequenced partial capital account liberalization and flexible exchange rates can give some degrees of freedom for monetary policy. Deep markets are a pre-requisite for more complete capital account convertibility.

More flexible exchange rates aid smoother and more counter-cyclical interest rates. Some exchange rate volatility induces hedging to reduce currency risk, but excess volatility raises country risk, expected depreciation, and interest rates. While limited volatility develops markets, high volatility encourages greater entry of noise traders and more speculative activity.

Thin markets require intervention to maintain volatility within bounds. But too predictable or unidirectional movements encourage speculative positions. Variation in a 10-band is sufficient to make such positions unattractive, since potential losses from an incorrect position become large. But large foreign exchange (FX) reserves and strategic intervention capabilities are required to sustain market confidence.

Limited volatility is consistent with maintaining a trend competitive real effective exchange rate. There is evidence such volatility does not have a large effect on trade, while excess volatility affects

trade adversely. If crises are avoided, interest rates lowered, and the longer-term exchange rate kept near competitive rates, trade is benefited.

In open economies with a large share of imported consumer goods, the exchange rate can be the fastest transmission channel to consumer prices. In South Asia, oil imports – which have a high pass through of exchange rate changes – dominate. As border prices begin to affect domestic food prices, the exchange rate becomes important for the domestic political economy. An appreciation when border prices rise can reduce the political pressures that raise agricultural procurement prices, and abort a rise in wages. This is one way of smoothing external shocks.

Appreciation when there is a negative supply shock, lowering intermediate goods (oil) and food prices, differs from fixing the exchange rate to bring down high levels of inflation – which led to real appreciation and often ended in a crisis in Latin American exchange-based stabilization episodes. Two-way movement only pre-empts the effect of temporary supply shocks on the domestic price-wage process. An exchange rate policy that lowers food price inflation reduces the necessity for subsidies and administered prices that distort incentives and lower efficiency. A rule-based automatic response to a supply shock avoids the tendency to do nothing until it becomes necessary to over-react. Actions linked to exogenous shocks also avoid moral hazard.

Nominal changes can counter temporary shocks as part of smoothing excess exchange rate volatility. But permanent shocks require productivity improvements. Without a rise in productivity, real appreciation would occur through inflation, requiring nominal depreciation as correction.

Thus, an exchange rate regime can stimulate the real sector, support external balance over the long run, lower inflation, and reduce FX market risks (Cordon, 2002). Lower inflation increases the Central Bank's ability to support the growth required to create adequate productive employment for SA countries' large populations.

3. Macroeconomic outcomes: Volatilities in open economies

Liberalizing reforms were meant to make the supply-side more robust and less sensitive to relative price shocks. The comparative picture of key macroeconomic variables for SA economies over the years in tables 2 (a, b) and 3 (a, b) shows the general similarities in the region: all the countries tended to have double deficits. India's foreign exchange reserves were the highest, but all the countries held reserves, and all had flexible exchange rates (Tables 3 a, b), pointing to some kind of managed float.

Table 2a: Selected economic indicators for South Asian countries

(2007, percent of gross domestic product unless otherwise noted)

	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
GDP per capita ($)	350.1	486.8	1,664.8	1,028.7	3,470.5	390.8	910.0	1,616.1
GDP Growth	11.5	6.4	17.0	9.0	7.6	2.6	6.8	6.8
Inflation	13.0	7.2	5.2	4.7	7.4	6.4	7.8	15.8
Fiscal Balance	(1.8)	(3.2)	(3.4)	(5.4)	(7.8)	(2.0)	(4.3)	(7.7)
Current Account Balance	0.9	1.4	10.5	(1.5)	(40.1)	(0.1)	(4.8)	(4.2)
Gross International Reserves (month of imports)	3.6	3.3	12.9	15.0	3.1	8.9	4.5	2.9
Money Supply (M2)	21.6	45.3	59.5	85.2	73.8	54.4	50.6	39.2
Bank Deposits	10.9	39.5	46.0	68.0	64.9	29.9	79.4	65.3
Government debt	18.9 (2006)	39.40	81.4	56.4	53.1	56	51.2	76.7
External debt	3.6	3.3	12.9	15	8.9	3.1	4.5	2.9
Foreign investment	5.4	2.7		5.2	8.01		6.1	2.3

Note: ( ) = negative

Sources: Statistical appendix and note a, ADB Key Indicators for Asia and the Pacific 2008. http://www.adb.org/Documents/Reports/South-Asia-Economic-Report/2009/chap2.pdf. Government debt: CIA World Factbook; External debt: www.adb.org

Table 2b: Selected economic indicators for South Asian countries

(2020, percent of gross domestic product unless otherwise noted)

	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
GDP per capita ($)	516.87	2233.31	3009.92	1910.42	7282.36	1139.19	1322.32	3893.84
GDP Growth	-2.35	3.45	-10.01	-6.60	-33.49	-2.37	-1.27	-3.47
Inflation (CPI)	5.61	5.69	5.63	6.62	-1.37	5.05	9.74	6.15
Fiscal Balance	-2.24	-4.80	-1.90	-4.65	-23.5	-3.37	-7.10	-10.53
Current Account Balance	-15.57	0.32	-16.39	1.23	-35.43	-0.25	-0.22	-1.27
Gross International Reserves ($mn)	0.28	193.11	6.55	5419.54	6.92	23.02	0.17	68.92
Broad Money	37.21	57.76	100.87	87.91	71.89	117.75	54.55	.....
Bank Deposits	17.96	48.64	90.43	74.97	61.19	103.11	36.91	92.73
Government debt	7.40	18.75	117.33	47.13	121.4	39.05	73.53	92.40

External debt stock % GNI	14.97	18.88	139.78	21.47	100.50	23.37	39.24	71.55
Foreign Direct Investment (net inflows)	0.06	0.41	-0.12	2.41	11.76	0.38	0.68	0.51

Source: Data from World Bank Data, Fred Economic data, IFS, CEIC website and Trading Economics

Table 3a: Averages and volatilities of inflation, exchange and interest rates

		Change in spot bilateral USD exchange rate	Inflation (WPI)	Call Money Rate	Long interest rate
India	**1981-92**				
	Average	10.7	8.1	11.3	16.8
	Standard dev	7.4	3.3	3.6	0.8
	1992-99				
	Average	8.5	7.2	10.2	15.2
	Standard dev	6	3.1	3.7	2
	1999-2007				
	Average	1.2	4.9	6.5	11.6
	Standard dev	4.9	1.3	1.7	0.8
Sri Lanka	**1981-92**				
	Average	8.5	11.3	19.3	14.6
	Standard dev	4.2	11.8	4.1	3.4
	1992-99				
	Average	7	7.9	22.9	17.3
	Standard dev	2.9	5.9	8.5	2.2
	1999-2007				
	Average	6.3	7.8	13.6	13.4
	Standard dev	5	7.5	7	3.3
Pakistan	**1981-92**				
	Average	8.2	8.1	7.7	9.1
	Standard dev	5.5	2.8	1.2	1.4
	1992-99				
	Average	9.6	10.2	10.2	10.9
	Standard dev	3.8	5	1.7	4
	1999-2007				
	Average	3.9	6.4	6.5	5.7
	Standard dev	6.4	2.2	2.8	2

Note: The long interest rate reported in the last column is Commercial Lending Rate-Prime for India, Minimum Unsecured Rate for Sri Lanka, and Government Bond Yield for Pakistan

Table 3b: Averages and volatilities of inflation, exchange and interest rates

		Change in spot bilateral USD exchange rate	Inflation (CPI)	Call Money Rate	Long interest rate
India	**2007-2013**				
	Average	5.44	9.43	9.22	8.09
	Standard dev	12.67	1.82	3.48	0.44
	2013-2021				
	Average	3.77	5.48	6.40	7.46
	Standard dev	5.52	2.06	1.97	0.83
Sri Lanka	**2007-2013**				
	Average	2.88	9.89	10.95	10.58
	Standard dev	4.72	6.77	3.12	1.67
	2013-2021				
	Average	5.26	4.93	7.24	11.80
	Standard dev	5.55	2.02	1.36	4.58
Pakistan	**2007-2013**				
	Average	8.74	11.96	11.00	11.89
	Standard dev	9.65	4.39	1.49	1.35
	2013-2021				
	Average	7.26	6.68	7.92	9.26
	Standard dev	9.32	2.93	1.82	2.26

Note: The exchange rate for India is calculated from the RBI database. Sri Lanka & Pakistan's exchange rate are calculated from the IFS database.

The period ending 2007 showed the culmination of reform efforts and of strong global growth. With some exceptions, growth rates were respectable and inflation rates moderate in 2007 (Tables 2a). Inflation, exchange rate depreciation, and interest rates had fallen in the 2000s compared to past decades (Table 3a). Tables 3 (a, b) report averages and standard deviations of exchange rate depreciation[5], inflation, and short and long interest rates for 3 countries.

Inflation, currency depreciation and interest rates all rose after 2007, with global volatility as a consequence of the GFC (Table 3b). Comparing 2007 with 2020 (Tables 2a and b) shows a sharp fall in reserves cover for the smaller countries, while Indian reserves had become substantial. Government and external debt rose strongly in Sri Lanka and Pakistan. This reduced their ability to smooth external shocks. Easily available but non-transparent infrastructure loans from China, as well as a larger share of commercial international government borrowing, contributed to this rise[6].

In the years of successive global shocks 2007-2013, inflation and interest rates rose. They fell as international fuel oil prices collapsed in 2014, but not enough to revive growth. Rising country risk premium kept rates higher in the smaller countries.

Prior to the liberalizing reforms, administered price and quantitative interventions repressed markets and kept volatility low, in a fragile equilibrium that broke down under large shocks (such as the external crisis in 1991). In the first reform decade, as controls were gradually lifted and markets freed, volatility increased. Although openness was itself a source of shocks, it increased diversity; together with the deepening of markets, this reduced volatility.

The pattern shows up clearly in ten-year moving averages of both average and standard deviation (Table 3a). There is an initial low, then a rise and fall pattern in volatility – reflecting the shift from restraints to markets and openness, with development of markets and institutions bringing fluctuations down by the third decade. In good times, volatility is generally low, as there are fewer external shocks; in deep markets also volatility is low.

The smaller SA countries tend to be more open, and were more strongly affected by external shocks. They had less market and capital account controls, and more government and international debt. Nepal also had the up-down pattern; Bangladesh had a steady downward trend. In Pakistan and Sri Lanka, internal unrest and political instability vitiated the pattern.

Over 1996-2003, average interest rates rose sharply, and their volatility exceeded that of exchange rates, partly due to the East Asian crisis and the use of interest rate defense. The volatility of capital flows was less than that of the current account deficit[7], since procyclical policies aggravated the latter. Initially, policy magnified shocks from openness instead of smoothing them.

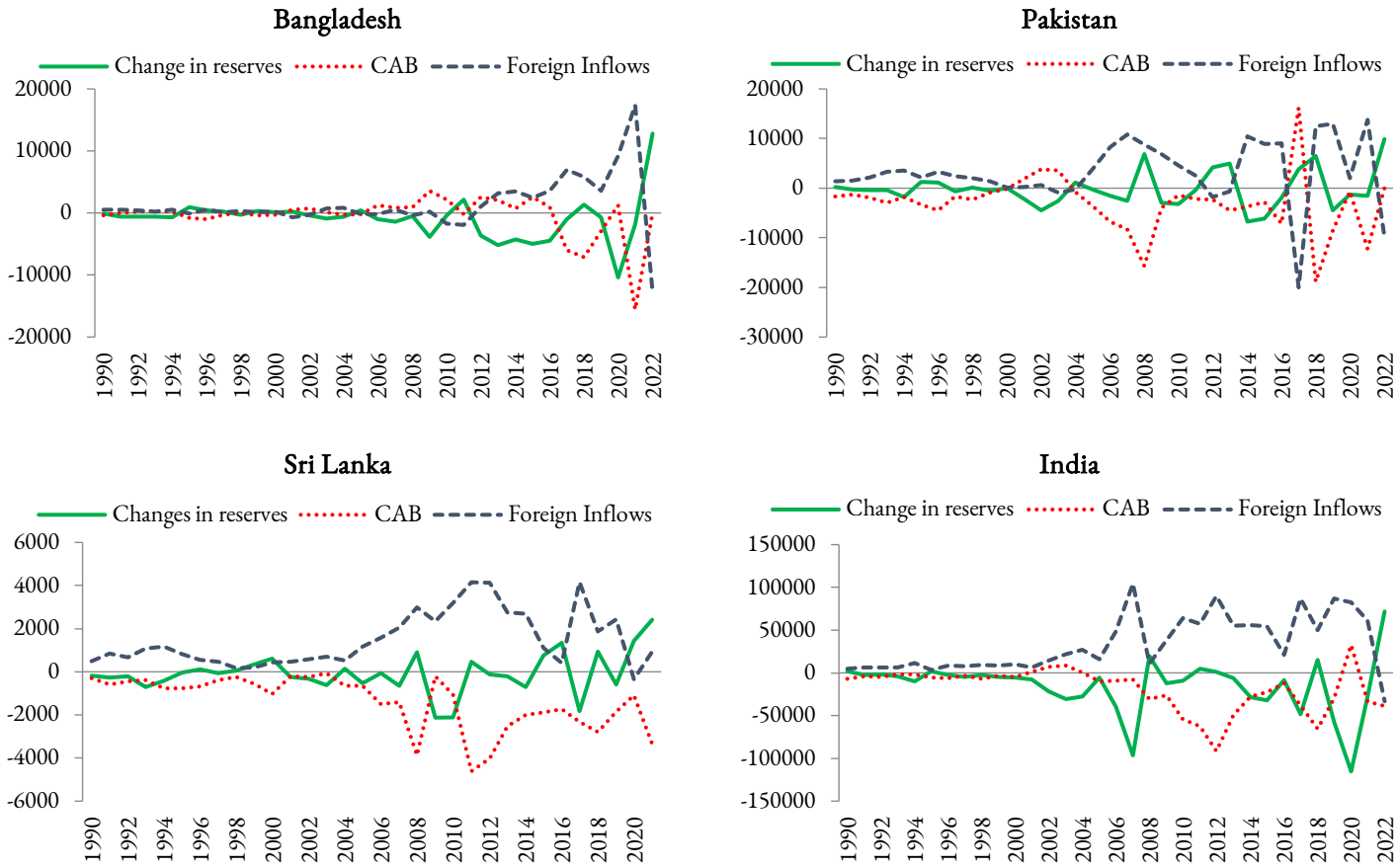
Less effective democratic pressures in Pakistan and Sri Lanka may have contributed to higher average inflation and depreciation there. Despite similar low per capita incomes, more volatility of inflation seems to have been acceptable than in democratic India, as Table 3 and the experience with the 2000s international food price shocks suggests.

The region was severely impacted by food and oil price shocks over 2007 and 2008. With political instability, capital outflows, and low reserves, Pakistan had to turn to the IMF for a rescue package. The sharp rise in interest rates imposed led to growth becoming negative (from an impressive 7%) over 2000-07. The international rise in food grain prices was passed on, contributing to double-digit inflation. But inflation dropped to low single digits by 2009[8]. In India also, procurement prices were raised, albeit not by as much; food price inflation was lower (but more persistent) as the price support system prevented domestic prices from falling when international prices fell.

The post-GFC period found the entire region more vulnerable. Deficits had widened. Indian public sector banks had been pushed to lend to private firms for infrastructure as part of the post-GFC global stimulus. The asset liability mismatch led to large non-performing assets. India embarked on a painful reform process, reduced the current account deficit (CAD) and built-up reserves.

Bangladesh's sterling export performance improved its external parameters. But none of the smaller countries were able to build sufficient reserves to withstand outflows in the pandemic-induced volatility (Figure 2). Government and external debt rose steeply in Pakistan and Sri Lanka (Table 2 a, b). The similarities of the earlier period gave way to divergences, as depreciation and interest rates in these countries exceeded Indian rates after 2013 (Table 3b).

Figure 2: External sector performance



Even as supply-side reforms continue to reduce domestic shocks, countercyclical policy must become feasible to smooth external shocks before the capital account can be made more fully convertible. Post-pandemic India came closest to fulfilling these conditions.

4. Macroeconomic Policies: Influences and Analysis

The stylized facts, structure, and experience corroborates the large impact of demand on output, the frequent supply shocks, and the importance of smoothing these. Policy analysis and narrative history for India goes more deeply into the structure, shocks, and politics that built in perverse incentives, the struggle to escape, and recent successes. Issues of monetary-fiscal coordination and sustainable debt and deficits are also explored.

4.1 Economic structure and shocks

India has a large population at low per-capita income levels. Therefore, poverty ratios and the share of food in the average consumption basket are high. The post-World War II control regime continued to target accelerated equitable development, according to the ideas of the time. But job growth was

low, due to the largely closed import substitution regime and controls that turned industry to rent seeking.

The early seventies saw severe oil shocks and sharp peaks in inflation, which hurt the poor. Since the latter were a large vote block, several user charges were kept fixed. Low price caps for many public goods resulted in systematic incentives to lower investment in and quality of public services, and to other distortions. Falling efficiency and rising costs compounded the problem of low user charges, and prevented a natural fall in prices from improvements in technology and organization. However, where the government had monopoly power and was servicing the rich, prices were raised much above costs of production. Indirect charges such as the prices of intermediate goods, not obvious to voters, were raised. As the rich turned to private providers, revenue losses contributed to the inability to service the poor adequately. Cross-subsidization was no longer sufficient to cover costs.

Populist fiscal response to supply shocks had a cumulative effect in trend worsening of public finances and growing public debt. The government began borrowing to finance current consumption in 1980-81, and was never able to return to a revenue surplus. Policies set in place vicious self-sustaining dynamics by creating favoured constituencies or interest groups.

4.2 Political and administrative changes

Political fragmentation made matters worse. As the Congress Party lost dominance in the 1970s and intense multi party competition set in, populist schemes multiplied, although targeting was poor. Waste and corruption proliferated. With multiple competing parties, swing votes became very important for winning in the first-past-the-post system. Poverty, caste, religious and regional heterogeneity encouraged use of identity politics to cultivate swing voters.

Frequent elections (after state elections were separated from those at the Centre in 1971) kept this pressure up continually. The democratic empowerment of the poor was a positive and necessary development, but symbolic gestures and handouts dominated in the poor Northern States. In the South, an older mass movement that emphasized education achieved progressive reform.

Administrative choices amounted to protecting the poor through current transfers, rather than building their assets and human capital, when it was the latter that was the sustainable option. Under pessimistic growth projections, this was a rational social outcome, because rich voters could often escape long-term deterioration and the poor had high discount rates so were focused on the present.

As fund constraints appeared, it was easiest to postpone investment plans. The financial sector was repressed with an administered interest rate structure. Large statutory liquidity requirements helped meet government borrowing requirements. Such quantitative measures restricted money supply growth despite automatic financing of government deficits. Interest rates were high, and many administered prices kept artificially low, but with a chronic upward bias.

The Government intervened in the food economy to ensure food security as well as to give incentives to farmers – who were also an important vote block, concentrated in a few States.

Procurement prices were often raised, while consumers were subsidized through a leaky public distribution system. The price gaps and costs of storage contributed to a mounting subsidy burden.

4.3 Macroeconomic policy

Early macroeconomic policy was geared to support planned expenditures. Since the seventies, dominant development ideas changed to favour openness. In India also, the ill-effects of controls were becoming obvious. Some liberalization started in the mid-'80s, but a major thrust for external openness came from a balance of payment crisis in the early '90s.

Post-reform macro-stabilization included a cut in public investment and monetary tightening, partly to sterilize capital inflows. Throughout this period, gradual financial reforms deepened markets. As most interest rates stopped being administered, it became a more effective policy instrument.

With the implementation of the liquidity adjustment facility (LAF) in 2001, policy was largely successful in keeping call money rates between the LAF bands determined by the repo and reverse repo rates, which began to be changed frequently and smoothly. There was steady reform also in Indian foreign exchange (FX) markets, and some two-way rupee movement in the 2000s after steady depreciation through the '90s.

The RBI now had more independence, with no automatic monetization or devolvement of primary issues of government securities. The fiscal deficit fell after a long time, with higher growth and lower interest rates, when the opposite policy of periodic rise in interest rates had not succeeded in reducing deficits over 1997-02. This lowering, however, did not occur from conscious policy choice, but because international interest rates were falling.

Inflation rose after severe international food price and oil shocks (2007-08) prompted a steep monetary tightening despite slowing industrial output. The GFC worsened the industrial slowdown. While a rapid monetary-fiscal response as part of the concerted global stimulus helped create a V-shaped recovery, stimulus was continued too long despite high food and consumer inflation. Regulatory softening hid risks building up in public sector banks.

As the Euro-debt crisis of 2011 and the taper tantrum of 2013 hit India and outflows threatened, over-tightening was the reaction to the earlier over-stimulus. As a result, growth slowed. For most EMs, global risk-on and risk-off resulted in much slower growth in the 2010s compared to the 2000s. Low growth prevented effective fiscal consolidation despite strong efforts.

Supply-side reform continued, however, and was better targeted at feasible technology-enabled changes, in line with India's comparative advantage. After initial attempts, the politically contentious land-labour-farm reforms, that are a favourite of foreign capital, were left to competition among states. Inflation targeting was formally adopted and strictly implemented. Since the focus was on structural reforms, however, smoothing was neglected. Regulatory over-reaction and absence of

liquidity support aggravated problems in non-bank financial companies, leading to a collapse in credit in 2019.

Monetary policy had begun correcting before the pandemic and was supportive through it. Regulatory remissions were now time-barred, creating better incentives. The financial sector had strengthened and was able to contribute to the stimulus. Macroeconomic policy found the correct balance between demand and supply-side measures. Over-stimulus was avoided. Intervention prevented excessive exchange rate volatility despite outflows, while domestic inflows kept stock markets stable. Increasing economic diversity helped absorb shocks. For example, a rise in service exports and remittances helped compensate for a slowdown in export growth. Robust recovery made India one of the best-performing economies in this dismal period.

4.4 Sustainable debt and fiscal reform

High government and external debt proved to be the Achilles heel for the smaller SA economies during the pandemic. In India also, government debt ratios were higher than its East Asian peers; however, sequenced capital account liberalization had limited external debt.

Reforms repeatedly aimed to improve fiscal health. But a norm of political populism had set in, where inclusion was sought through short-term transfers. The 2003 Fiscal Responsibility and Budget Management (FRBM) Act was not designed to protect investment, so productive expenditure was cut to continue populist spending. This was especially so for states that had limits on their borrowing. Targets were mechanically achieved, compressing essential expenditure on infrastructure, health, and education, so public services deteriorated.

Given fiscal populism, cost creep, and political sensitivity to inflation, the RBI was often forced to tighten. Moreover, interest elasticities were thought to be low, due to a large subsistence sector little impacted by interest rates. The impact of recently-freed interest rates on elasticities, in particular on consumer durable spending, housing, etc. was not yet fully understood.

Higher growth over 2003-08 did reduce debt levels, but large procyclical revenue expenditures moderated deficit reduction. Indian private savings are high enough to cover for some government dissaving, thus mitigating the CAD and currency risks, but a permanent rise in expenditure – in excess of taxing capacity – can lead to instability (Goyal 2011). A large fiscal stimulus given during the GFC was not reversed for a number of years.

Since catch-up growth was volatile and had fallen in the 2010s, debt ratios did not reduce adequately. This was despite strenuous efforts at fiscal consolidation, after outflows threatened with the Euro-debt crisis, and the election of a central government committed to fiscal conservatism.

Higher growth raises the denominator of ratios as well as revenues. Ratios shot up in the pandemic year, despite limited and targeted fiscal stimulus, since growth was negative at -6.6%. But consolidation resumed the very next year, helped by a good growth recovery, reduction in deficits, and shift in the composition of government expenditure towards investment. The latter improves human

and physical capital, and therefore the supply response. Continuing improvement in tax rates, structure, and administration, as well as higher growth, contributed to tax buoyancy. Better incentives were created for compliance of state governments.

4.5 Monetary-fiscal coordination

The post-90s-reform Indian macro policy combination was largely fiscal loosening and monetary tightening. Adverse consequences inevitably followed in a framework such as Figure 1, where demand contraction has a large effect on output and little on inflation. The period of double deficits after the GFC created monetary dominance and over-tightening.

With SA's structure and shocks, fiscal action is more effective against inflationary supply-side shocks. Also, the interest sensitivity of demand is high, with a youthful population at the borrowing stage of its life-cycle. Since each affects the other's objective, the ideal combination is a conservative fiscal policy and pro-growth monetary policy (Goyal, 2018).

The post-pandemic period demonstrated the benefits of such coordination. As deficits were reduced and effective supply-side fiscal action lowered inflation, monetary policy was able to keep real interest low and near equilibrium level. The commitment under inflation targeting (to raise rates if inflation exceeded the tolerance band) made monetary policy credible. It helped anchor inflation expectations, and kept inflation largely within the tolerance band, despite supply chain snarls and geopolitics-related commodity price shocks. Higher growth helped fiscal consolidation.

5. Conclusion

Stylized facts show the dominance of supply shocks, amplified by openness and procyclical macroeconomic policy. In India, the pandemic period demonstrated the feasibility and utility of a smoothing policy response through better coordination between monetary and fiscal policies, together with cost reduction through pragmatic reforms. Such contextual policy that avoids extremes is more suited to SA structure and to the process of change. Shocks continue to be large and frequent, but growing economic diversity, steady market development, countercyclical macroeconomic policy, and use of buffers are helping absorb shocks without reducing growth.

Transferring its large labour endowment to more productive work can be a major strength for the SA region. This reduces the risk from government debt and deficits, as long as government expenditures enable the supply response from the large numbers willing and able to work.

While in a low-growth environment, indirect benefits maybe discounted because of their uncertainty and greater chance of going to others, voters nonetheless prefer being equipped to make use of opportunities, especially as these accelerate. There are signs of this in India, but policies need to improve to more fully energize the individual and the society, even while protecting vulnerable sections.

Apart from geopolitical tensions, a major risk is populism that continues to offer freebies, especially in states. This reduces resources for improving essential public services. Although limits on state borrowing prevent macroeconomic instability, they imply higher share of government consumption expenditure must be at the expense of investment.

The smaller countries in the region were also doing well until the GFC. But the inability to self-insure against continued global shocks and the lure of easy debt aggravated political fragilities. Better global safety nets, debt resolution, and fiscal discipline are essential for EMs trying to navigate today's choppy seas. With the focus on climate change, debt-for-nature swaps, for which better measurement and transparency is a prerequisite, hold promise as a way of restructuring debt.

References

Aguiar M. and G. Gopinath. 2007. 'Emerging market business cycles: the cycle is the trend'. *Journal of Political Economy*, 115(1): 69-102. https://www.journals.uchicago.edu/doi/10.1086/511283

Calvo, G.A. and C. A. Vegh. 1999. 'Inflation stabilisation and BOP crises in developing countries.' in Taylor, John B. and Michael Woodford (Editors), 1999, *Handbook of Macroeconomics*, Vol.1 Elsevier: North Holland.

Corden, W.M. 2002. *Too sensational: on the choice of exchange rate regimes*, Cambridge MA: MIT Press.

Goyal A. 2018. 'The Indian fiscal-monetary framework: dominance or coordination?' *International Journal of Development and Conflict*, 8(1): 01-13. June. http://www.ijdc.org.in/uploads/1/7/5/7/17570463/jun_18_art_1_goyal.pdf

Goyal A. 2015. 'Understanding high inflation trend in India.' *South Asian Journal of Macroeconomics and Public Finance*, 4(1): 1–44. https://journals.sagepub.com/doi/full/10.1177/2277978715574614

Goyal A. 2012. 'Propagation mechanisms in inflation: governance as key.' Chapter 3 in S. Mahendra Dev (ed.), *India Development Report 2012*, pp. 32-46, New Delhi: IGIDR and Oxford University Press.

Goyal A. 2011. 'Sustainable debt and deficits in emerging markets.' *International Journal of Trade and Global Markets*, 4(2): 113-136.

Notes

[1] The data are smoothed using the Hodrick-Prescott (HP) filter to remove short-run fluctuations. For quarterly series 1600 is used as the smoothing parameter. Since yearly data are observed only one-fourth as often as quarterly data, the value used is $1600/4^4 = 6.25$. Critical correlations were also calculated with unfiltered data and with 100 as the smoothing parameter, with similar results.

[2] Exceptions are very low countercyclical for India (-0.03 with a smoothing parameter of 100), and very high countercyclical for Nepal.

[3] After his visit to Kalahandi in Orissa, the late Rajiv Gandhi said only about 15% of money meant for the poor actually reaches them. A Supreme Court panel passed severe strictures on the public distribution scheme in 2010, corroborating this assessment.

[4] There is no problem if average wages rise with agricultural productivity. But the push to minimum wages, without the latter, under the national rural employment guarantee, may have contributed to the rise in consumer price inflation over 2007-2013.

[5] It is calculated as the percentage change in average monthly local currency/USD rates.

[6] News reports put share of Chinese loans in external debt at 20% for Sri Lanka's, 30% for Pakistan and 7% for Bangladesh in 2023. Negotiating urgently required IMF loans became difficult since China would not agree to the restructuring that was an IMF pre-condition.

[7] The coefficient of variation of the CAD was –1.97 compared to only 0.19 for foreign inflows.

[8] In Sri Lanka inflation fell from 28.2 per cent in June 2008 to 4.8 per cent at end 2009.