

PROF B R SHENOY MEMORIAL LECTURE 2022

INDIA MACROECONOMIC CHALLENGES ON THE PATH TO A \$5 TRILLION ECONOMY - DR DUVVURI SUBBARAO

Good evening everyone and welcome to the BR Shenoy Memorial lecture 2022 with Dr D Subbarao as our speaker. My name is Kumar Anand and I will be your moderator this evening.

The talk by Dr D Subbarao will be for about 45 minutes, after which we will have about 30 minutes for question-and-answer session with the audience who are joining us live.

You can type your questions in the Q&A segment in the Zoom here or in the YouTube section, wherever you are joining us from.

This lecture series is instituted in the memory of the late Indian Economist Professor B R Shenoy.

In early years of the Indian Republic, Professor Shenoy's was the lone voice that dissented from the prevailing view that Economic Policy should focus on Soviet-style Central planning, State-led industrialization with focus on heavy Industries and State-owned Enterprises with limited concern for what was actually needed by Indian consumers in a predominantly agriculture economy at the time.

So, Professor Shenoy's insights into the powerful positive social good done by a responsive competitive market economy was vindicated by structural reforms, economic reforms which were undertaken in 1991. That enabled a relatively fast-paced economic growth and large reductions in poverty in the years that followed.

The importance and impact of Professor Shenoy's ideas have been noted by previous speakers in this Annual Memorial lecture series including by Sri Montek Singh Ahluwalia, Shri Bibek Debroy and Dr Parth J Shah among others.

Professor BR Shenoy tirelessly argued for new thinking and practical policies that would build a stronger Indian economy. Had his ideas been implemented in say, 1960s, when India, South Korea and China had comparable and very low level of per capita income then maybe India would have been a middle-income country by now.

Nonetheless, we can still achieve this with a strong second wave of reforms and careful steering of the Indian economy through these turbulent external Global conditions partly inspired by Professor B R Shenoy's ideas in making the right choices.

Our speaker today has great experience in such careful steering and making the right choices and has a vision of how to reach an aspirational national benchmark, such as becoming a five trillion-dollar economy.

Dr Duvvuri Subbarao was the Governor of the Reserve Bank of India from 2008 to 2013, and is generally credited as having safely stewarded Indian economy through the global financial crisis.

Until recently, he was a distinguished visiting faculty at the National University of Singapore and the University of Pennsylvania. In earlier years, Dr Subbarao worked as a Joint Secretary in the Department of Economic Affairs at Ministry of Finance, from 1988 to '93. Subsequently, he became the Finance Secretary to the Government of Andhra Pradesh, followed by becoming the Lead Economist at the World Bank from 1999-2004.

He was then appointed by the Prime Minister's Economic Advisory Council in 2005 before he was elevated to the Finance Secretary position in Government of India in 2007.

Dr Subbarao was involved in the initiation of fiscal reforms at State level and produced a flagship study on decentralization across major countries in East Asia including China, Indonesia, Vietnam, Philippines, and Cambodia.

Dr Subbarao's book on his RBI tenure, 'Who Moved My Interest Rate - Leading the Reserve Bank of India through Five Turbulent Years' was published in July 2016.

*On behalf of the Centre for Civil Society, New Delhi, Founder Dr Parth J Shah and the CEO Ms Lakshmi S Goyal, and on behalf of Economic Research Centre Trust, Mangalore, Chairman Giridhar Prabhu and my fellow bearers, ERC board members Mr M N Pai and Professor Subodh R Shenoy, it gives me great pleasure to invite our speaker Dr D Subbarao for the B R Shenoy Memorial Lecture 2022 to speak on “**Macroeconomic Challenges on the Path to a Five Trillion-Dollar Economy**”. Dr Subbarao.*

India
Macroeconomic Challenges on the
Path to a \$5 Trillion Economy

BR Shenoy Memorial Lecture - 2022

November 2022

Duvvuri Subbarao (Subba)



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Dr Subbarao

Thank you very much. First of all, my thanks to the Centre for Civil Society and the Economic Research Centre for inviting me to deliver the Shenoy Memorial Lecture. It's an honour and privilege.

Professor Shenoy was a distinguished economist, a liberal thinker, pioneer of free market ideology. He was a freedom fighter and an illustrious teacher. But for all of us, associated with the Reserve Bank of India, he was very special. He was an Economist in the Reserve Bank of India and as far back as in 1946, wrote a seminal paper on India's Sterling Reserves, arguing that the rupee must be devalued against the Sterling Pound.

2nd Five Year Plan (1956-61) Economic Philosophy

- India has to be self sufficient with little dependence on external trade and investment.
- Capital intensive industrialization is the route to growth.
- The public sector must occupy the commanding heights of the economy.
- Extensive state control is necessary to conserve scarce capital and ensure balanced development.



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Professor Shenoy is most remembered today for his **Note of Dissent** to the 2nd Five-Year Plan. The 2nd Five-Year Plan, as we know, which ran from 1956-'61 define the philosophy, the

ideology that would govern India's economic management for the next three decades. It made a commitment to self-sufficiency, gave prime importance to capital intensive industrialization led by public sector investment and believed that the State must actively control the market in order that scarce resources are conserved.

Prime Minister Nehru at that time invited country's economists to comment on and critique the 2nd Five-Year Plan. Professor Shenoy was one of them.

Professor Shenoy notably dissented from the approach to the 2nd Five-Year Plan. His point was that India cannot finance the heavy industry investment all by itself. That

Prof. Shenoy's Note of Dissent

- India cannot finance the heavy industry investment all by itself.
- Government intervention in the market will lead to distortions.
- Central planning with no heed to market forces will put the economy in the wrong direction.



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Government intervention in the market will lead to distortions; and Central

planning with no heed to market forces will put the economy in the wrong direction. In the event, Professor Shenoy did not prevail.

India embarked on a closed economy heavily controlled path. We got locked into Hindu rate of growth and the rest is history. In history, there are no counter factors. But, where India would have been today, if we had heeded the advice of Prof Shenoy and people like him, will forever remain a conjecture. But even though Professor Shenoy did not prevail. His Note of Dissent was notable in my view for two reasons.

First it is notable because he went against the prevailing orthodoxy. The prevailing orthodoxy - throw your mind back to the 50s and 60s, was exactly the orthodoxy that India followed. Self-sufficiency, intervention in the market and capital-intensive industrialization - that's what every economy coming out of colonization in the 50s and 60s followed, and Dr Shenoy was ahead of his time.

The second reason his dissent was notable was because he had the courage of conviction to go against the economic orthodoxy. Again, throw your mind back to the 50s and 60s, Soviet economic model was a mesmerizing thing to everyone; practically everyone believed that the Soviet economy would dominate the world.

Pre-eminent Economist of the time, Paul Samuelson said that the Soviet Union will overtake the U.S in 1984. Professor Shenoy was one of the very few who dissented against Soviet model. But it's not as if economists who had no influence in real time have no influence at all. In fact, this is what Keynes said.

Keynes on the Influence of Economists

“Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.”



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That the practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.

Indeed, that's exactly what happened in India when we embarked on the 1991 reforms.

It was in a sense vindication of people like Professor Sheno and others who believed in free market ideology.

The 1991 reforms renounced self-sufficiency, dismantled the license permit regime, and eschewed commitment to the public sector.

1991 Economic Reforms A Sharp Break from the Past

- Renounced self-sufficiency. Liberalized trade and investment.
- Dismantled the licence-permit regime.
- Eschewed commitment to the public sector



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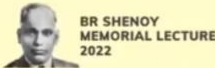


Today, 30 years later,

there is a lot of mythology, a lot of folklore about the causes for the 91 reforms. There were proximate causes, there were structural causes. But certainly, one of the other underlying causes was the osmosis of ideas like that of Prof Sheno.

So, in the 30 years since 1991, India did implement some significant second-generation reforms - GST, for example, liberalising foreign direct investment.

**In the Three Decades since the
1991 Economic Reforms**

Despair that 2nd generation reforms have
become hostage to divisive politics and
contentious federalism.

But there is generally some despair that we've lost the momentum, we've lost the enthusiasm of the 1991 reforms and the second-generation reforms to tell admittedly, politically more difficult have become hostage to divisive politics and contentious federalism.




So, people ask a related question, which is, if we cannot implement 2nd generation reforms, how will we ever get to a \$5 trillion economy?

You all recall that when Prime Minister Modi returned to office for a second term in 2019, he set a national aspiration of five trillion dollars of GDP by 2024-'25. Economists did the calculation and said that if you have to reach \$5 trillion by 2024-'25, I'm talking about 2019, they said we had to grow at 9% in real terms, 14% in nominal terms. That looked very very difficult.

If that looked difficult in 2019, it is almost impossible today after Covid and with the ongoing War. We will of course get to 5 trillion. Economists now say we'll get there by 2028-'29. We will get there possibly a year earlier, perhaps, a year

**When and how will we get to a
\$5 trillion economy?**

- After a resounding victory in 2019, PM Modi set a national goal of \$5 trillion of GDP by 2024/25.
- Achieving the goal by 2024/25 looked difficult even then.
- Looks certainly impossible today.
- We will of course get to \$5 trillion. But how quickly will we get there?
- And 'how' we get there is as important as how quickly we get there.

later but we'll certainly get there.

But here's my point. How quickly we get there is important but how we get there is equally important. Why do I say that? I say that because we need growth with widely shared prosperity only then will we get to \$5 trillion.

We can reach \$5 trillion by inflating the economy, we can reach \$5 trillion by just top 10 percent of the population becoming richer, getting better, with the bottom ninety percent remaining where they are. But that's not the type of \$5 trillion we want. We want a \$5 trillion growth with widely shared prosperity.

We have to look ahead to how we get to 5 trillion. But in order to look ahead, we also need to look back. Especially, because this year we're celebrating 75

India - \$5 Trillion Aspiration
In the Context of *Azadi ka Amrit Mahotsav*

Looking back to look ahead
Significant progress in the last 75
years since Independence

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years of
Independence –
*Azadi ka Amrit
Mahotsav.*

So, we've achieved
quite a lot in the last
75 years. And one of
the ways of
appreciating how

much we've achieved in the last 75 years is look at today's world from the eyes of a 10-year-old girl.

Think of a 10-year-old girl today and compare her life with that of her

grandmother, born around the time of Independence. The 10-year-old girl today is wearing a uniform to go to school, probably on a cycle. Her grandmother never ever saw a school.

This 10-year-old girl has the benefit of nutrition as an infant through the ICDS, has the

benefit for mid-day meal program in school. Her grandmother never ever saw school, she was malnourished, sick all the time.

This 10-year-old girl today has a 50% probability of having access to a toilet. Her grandmother had to wait until it was dark and therefore was vulnerable to many infections. The grandmother was probably married at 15, had four children by the time she was 22 and was not sure how many will survive?

This girl today probably will not get married until she's 30. She will have two children at most and she will decide when to have too.

So, that's how much India has changed in the last 75 years.



I have put together here some socio-economic indicators to show the enormous amount of progress that we made – in social indicators, in economic indicators. But the most important thing - Remember, at the time of Independence, we

India 1951-2022		
	Then (1951)	Now (2022)
Population	361 million	1400 million
Life Expectancy	36.7 years	69.5 years
Females/1000 Males	946	1020
Literacy (Males)	27.2%	84.4%
Literacy (Females)	8.9%	71.5%
Crude Steel	1.2 MMT	118.0 MMT
Roads	40,000 km	63,71,847 km
Railways	53,596 Route km	68,000 Route km
Registered Vehicles	0.3 million	295.8 million

were a food scarce economy. Hunger and malnutrition were very common. Famine occasionally used to be there.

In fact, we used to live from ship to mouth, you could say that. Wheat has to come under the PL-

480 program from the U.S that were unloaded and moved to people across the villages in India, which lived from ship to mouth.

Today we are a food exporting country. We are the largest producer of milk in the world. We are the second largest producer of rice and wheat. We have a space programs, we have IITs, and IIMs. We have

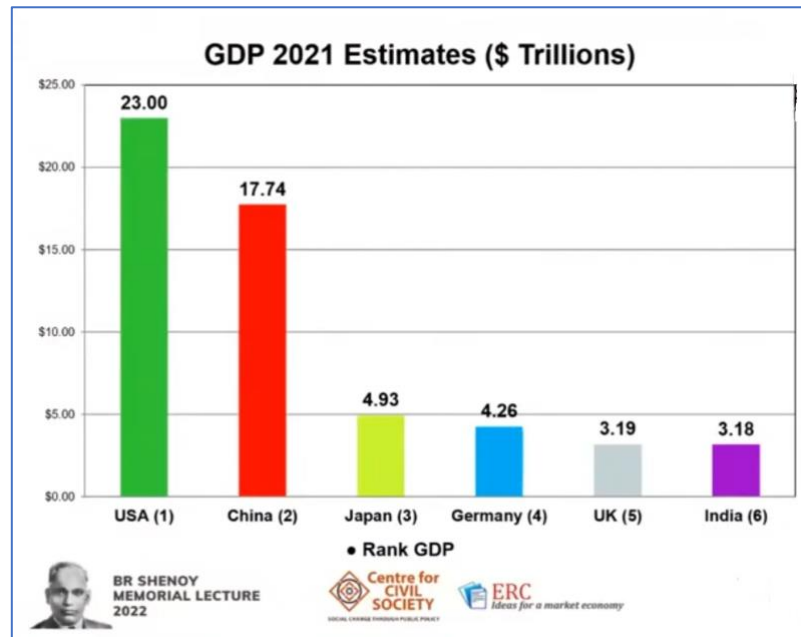
India - \$5 Trillion Aspiration

What is the big picture?

Cricket, we have Bollywood. So, that's the enormous amount of progress we

have made. So, we have to build on that to get to a five trillion-dollar economy. So, what is the big picture on the way to the five trillion?

Here's the big picture. If you take countries around the world by the GDP measure, India comes 6th behind the USA, China, Japan, Germany 4th, UK 5th, and India 6th.



I believe recently we have overtaken the UK, but it is minute and very very close. I have taken the IMF numbers of 2021.

So, we are the 6th largest economy in the world.

We are a large economy because we have a huge population of 1.4 billion people. But we are also a poor country.

One standard measure of comparing countries on welfare is their per capita income.

India – The \$5 Trillion Aspiration

- India is a large economy
- But India is also a poor country

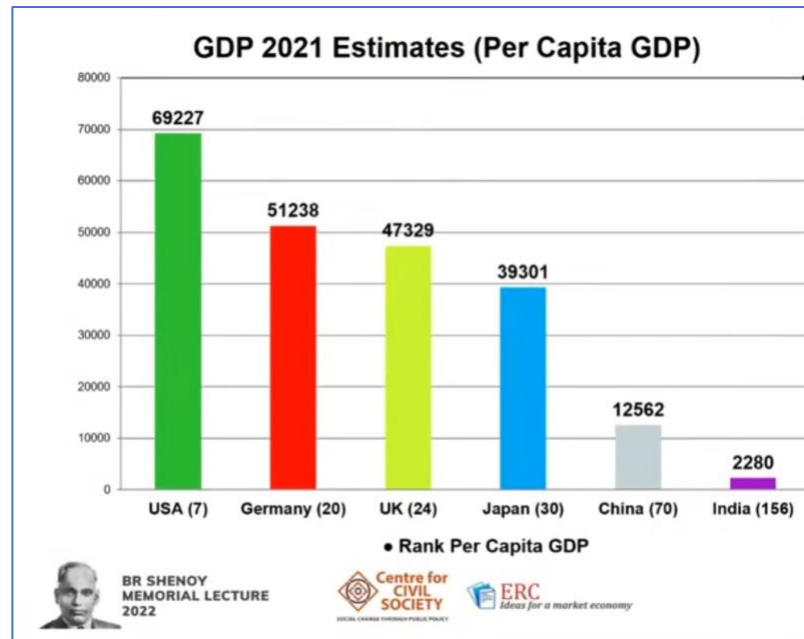
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If we take that as the measure, here is where India stands, at number 156, in the bottom league of Nations in the World.

USA is at 7, Germany at 20, UK at 24, Japan at 30, China at 70. India is at 156 with a per capita income of 2280.



India – The \$5 Trillion Aspiration

- India is a large economy
- But India is also a poor country
 - Poorest in the G-20
 - Poorest among BRICS
 - More poor people than the entire continent of Africa

So, India is a large economy but it's also a poor country. We are the poorest in the G-20. We are the poorest among BRICS. We have more poor people than the entire continent of Africa.

And it is from here that we want to get to a \$5 trillion.

In order to get to \$5 trillion, we need rapid growth. But we also need poverty reducing growth. Not just any growth, but poverty reducing growth, which is growth which is widely shared.

India – The \$5 Trillion Aspiration

- We need rapid growth
- We also need poverty reducing growth

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In order to get there, we have many challenges along several dimensions - political challenges, macroeconomic challenges, human resource challenges, institutional challenges, and governance challenges.

**India – The \$5 Trillion Aspiration
Many Challenges on the Way**

- Political challenges
- Macroeconomic challenges
- Human Resource challenges
- Institutional challenges
- Governance challenges

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Over the next 25 minutes or so, I am going to focus on the macroeconomic challenges India will have to manage in order to get the 5 trillion.



In particular. I'm going to focus on **seven** key macroeconomic challenges.

The first challenge obviously is to accelerate the growth rate. One of the questions that has historically been asked, that we ourselves said is – *“Is it possible for a large economy to grow rapidly?”*

In the early decades of Independence, we acquiesced in low growth rate. We thought we were destined to a Hindu rate of growth, 3.5% - 4%, that a large economy cannot grow any faster than this.




In the 1980s, we know that the East Asian economies - the East Asian tigers - Hong Kong, Singapore, Taiwan, Korea, mesmerized the world with the phenomenal growth, moved from low income to middle income and some of them into high income economies, in a matter of one and a half generations.


But we were dismissive of that. We said okay, it is okay, it is possible for small economies to grow rapidly, but a large economy like India cannot grow rapidly. But starting 1990, China posted spectacular growth – double digit growth on a trot for three years. India was shaken. India was jolted in a way.

We were even inspired by China's growth. It is instructive for us. I just want to compare India and China.

India – the \$5 Trillion Aspiration
India – China Hyphenation

- In 1990, India and China were at around the same level.
- After 1990, China zoomed while India just lumbered along.
- Can the elephant ever mimic the dragon?
- China's disdain and India's despair

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China, we know opened up in 1979 under Deng, and India in 1991 about 12 years later, approximately a decade's difference between India and China opening up. In 1990, India and China were at around

the same level. After 1990, China zoomed while India just lumbered along.

And forever, the question we are asking today is, can the Elephant ever mimic the Dragon?

If you compare India and China, China as I said posted double digit growth for three decades on a trot. India never posted eight plus percent growth for longer than three years except once in the last 50 years.

In the 20-year period, between 2000 and 2020, China's GDP as a proportion of World GDP multiplied four times. India's just stopped. China's per capita

income is more than five times in eight years. China is the largest trading nation in the world. China is the largest manufacturing nation in the World.

India's share in global trade and in global manufacturing is in single digits. China is a high middle income country trying to get to high income. India is a low middle income country forever worried that we might get locked into low income. So, that's the contrast between India and China.

Macroeconomic Challenges on the Path to a \$5 Trillion Economy

1st Challenge
Accelerate the Growth Rate

- Is it possible for a large economy to grow rapidly?
- Single most important thing to accelerate growth – raise investment
- Raising the level of investment is necessary but not sufficient.

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So, the single most important thing to do is to accelerate the growth.

And if you ask me what is the one thing we have to accelerate growth, I will say **Investment**.

Economists say we know that growth comes from consumption, investment - both public investment and private investment, and net exports. But of all these elements, I would think investment is the most important. Because today's investment is tomorrow's production capacity. So, we need to increase investment.

Over the last 10 years, investment has been dented because of the twin deficit problem, because of Covid, because of the War, whatever reason. But investment is not just picking up. And if we need to grow rapidly, we need investment like when we grew at nine to ten percent.

I said, if you ask me, one thing I will say is investment. But all one-word answers about India are wrong. So, we need more than investment and what we need is to improve the productivity of that investment. We need infrastructure, we need skills to improve productivity, and importantly, we need good governance. Because transaction costs sank productivity of investment in India. We know that.

When I was Finance Secretary in Andhra Pradesh, as well as Finance secretary in Government of India, in Delhi, a lot of foreign investors used to come to us and say that - *We want to invest in India. We are going to invest five billion dollars, six billion dollars*, and then talk to us about what concessions we would give - both at the State level and at the National level. And for good measure they will say - *We were in Shanghai yesterday and we just flew into Mumbai or Delhi*. And we used to ask - *What did the Chinese promise you?* And they say - *The Chinese promises this, this, this, this*. And we say - *How long did the Chinese say they will take?* And they said, *Chinese say it will take six months, to deliver all this*.

So, we used to say, *Oh, the Chinese said six months? We will deliver this in three months!*

The Chinese having promised they will deliver in six months will deliver in three months. The Indians having promised that we will deliver in three months will probably not deliver even three years! That is the stark contrast of the transaction costs between India and China.


I'm just giving you an exaggerated example. But there are any number of illustrations to prove the enormously high transaction costs for investment in


India. So, the first challenge to getting to a 5 Trillion economy is to accelerate the growth.


**Macroeconomic Challenges on the
Path to a \$5 Trillion Economy**

**2nd Challenge
Reduce Inequality**

- India is one of the most unequal societies in the world.
- Far from narrowing, inequality is widening.
- The pandemic has further widened inequalities.
- Inequality is morally wrong and politically corrosive. It is also bad economics.

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The second challenge is reducing inequality.

India is one of the most unequal societies in the world today. What is even more distressing is that far from narrowing, inequality is actually widening. Inequality across any dimension - whether you take

income, you take wealth, you take carbon footprint.

Take income inequality for example. The bottom 50 percent, the bottom half of the population in India today get 13% of the overall income. The top 10% get 57% of the total income. So, the bottom half get just 13% and the top 10% get 57%. That's a very very stark inequality. If you actually take wealth and carbon footprint, and other dimensions, the inequality is even more stark.

What is even more distressing is that the pandemic has further widened inequalities. Last year, during the Omicron wave, when we had lockdowns in several parts of the country, when millions of people were gasping for oxygen outside hospitals, Mercedes recorded the maximum number of sales of its top end SUV.

During 2021-'22, when the economy went through the biggest contraction since Independence, when 75 million people are suspected to have retreated back into poverty, the number of dollar billionaires in the country went up from 102 to 150. So, the pandemic in a way widened inequalities. Inequality is morally wrong. You all understand that. It is just not right that some people are better off and some people are forever condemned to low quality living. It is politically corrosive. We understand that as well.

What we don't understand as much is that it is also bad economics. Because, if the bottom 50 percent do not get a share of prosperity, if they do not get a share of growth, if they do not consume, we cannot grow. In fact, one of India's strong growth drivers is our enormous growth potential, 300-400 million people are living at low to middle incomes. If their incomes go up, then they will get money to consume and that consumption will spur investment, which will spur growth, which will spur further jobs and we can reduce inequality.

So, there is no path for us to reduce inequality unless we ensure that whatever growth we generate, the benefits of it particularly go to the bottom 50%. In other words, the bottom 50% contribute to growth and they benefit from

growth.

The third challenge on my list of challenges is Low and Steady inflation.

Why is low and steady inflation important?

It is important; because for investment, for consumption,




Macroeconomic Challenges on the Path to a \$5 Trillion Economy

3rd Challenge
Low and Steady Inflation

- Why is low and steady inflation important?
- Is there a trade-off between rapid growth and steady inflation?
- Tension between savers and borrowers?
- Monetary policy calibration in a globalizing world – the challenge of the 'impossible trinity'

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which are growth drivers, low and steady inflation is necessary. People want a predictable economic environment in order to decide to invest. People want a predictable economic environment in order to consume.

If, for example, an apartment costs 45 lakhs today, and it's going to cost 50 lakhs in January, 48 lakhs in March, and 62 lakhs in June next year, you cannot make an investment decision. You want a steady inflation. You want predictable economic environment. A steady inflation is a necessary condition for predictable economic environment.

Steady inflation growth is also important. Because inflation is a regressive tax. It hurts poor people much more than it hurts others. If, for example, the price of rice goes up from 50 per kg to 55 per kg, at my level of income, I may not have been noticed that; but for most poor people it would mean putting some food on the table, putting food in the plates of their children. So, inflation is a regressive tax. If we want to spread prosperity we need steady inflation.

Steady inflation is also important in order to maintain competitiveness because high inflation saps our competitiveness and saps our export potential. One of the tensions, policy dilemmas, struggles - for any Central Bank, particularly, a Central Bank like that of India, the Reserve Bank of India is this trade-off between rapid growth and steady inflation.

All of us who follow the RBI policy announcements invariably see this tension play of commentators, economists ask that if RBI is going to raise the interest rates to control inflation, is that not going to hurt growth?

But I don't want to give the impression that this is a question only for emerging economists. In the U.S today it is a big question. As the FOMC's meeting

today, the biggest question is, are they going to raise interest rates and take chances on pushing the economy into recession in order to control inflation? Are they going to take care of recession and tolerate some inflation?

So, this trade-off between growth and inflation is a perennial tension for Central Banks. But here's what I want to say, which is that the trade-off if at all is in the short term. In the long term, there is no trade-off between growth and steady inflation. RBI research shows that if inflation is above four percent it is inimical to growth and if it is above six percent it definitely hurts growth. So, we need steady inflation to accelerate growth.

And there is another thing, all the time we talk about RBI interest rates, we are concerned about maintaining low interest rates for borrowers. We seldom ever worry about giving high interest rates to savers. After all, we need savings because savings turn into investment and investment turns into production and jobs. So, without high savings we cannot accelerate growth and we cannot get high savings without a high interest rate.

As RBI Governor, I once went to Chandigarh and I met the Small Medium Industries Association. What was their demand? Their demand was that interest rate must come down. Soon after, actually at the next meeting, I met with the Pensioners Association. What do pensioners want? What pensioners want was high interest rates.

So, RBI has to struggle between giving a high enough interest rate to pensioners, depositors and the savers and lower the interest rates to borrowers. And the final thing, which we all need to understand we need to understand the macroeconomic challenges is that calibrating monetary policy in a globalizing world is becoming increasingly difficult.

If you look at RBI policy documents 20 years ago, even 15 years ago, you would not have seen any reference to the global economy. The policy would have been made entirely by looking at domestic circumstances. The entire document would have been on domestic economy.

Today, RBI produces a policy document that's about 12 paragraphs, usually about two paragraphs, certainly at least one paragraph, is on the global economy. Why? Because we are integrated into the world.

So, what happens around the world matters. In particular, what happens in advanced economies, more particularly, what happens in the American economy matters to us.

For example, over the last one year, particularly over the last six months, we've seen capital outflows because of tightened financial conditions, the rupee depreciate as a consequence to that and RBI today is caught in a dilemma of whether to focus on monetary policy or focus on managing the exchange rate; and we are caught in a very impossible trinity, which says that no economy can at the same time have an open capital account of fixed exchange rate and a completely independent monetary policy.

So, in order to accelerate growth, we need a steady inflation. And one of the challenges for maintaining steady inflation rate is to manage this impossible trinity.

Which allows me to segue into my fourth challenge, which is to maintain a stable exchange rate.

Stable does not mean a fixed exchange rate.

Stable means a steady exchange rate with no volatility.

Why is a stable exchange very important?

Macroeconomic Challenges on the Path to a \$5 Trillion Economy

4th Challenge

Maintain a Stable Exchange Rate

- Stable does not mean fixed exchange rate
- Why is a stable exchange rate important?
- RBI policy in managing the exchange rate – in theory and in practice.
- RBI's exchange rate dilemma in today's context

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A stable exchange rate is important for the same reason that steady inflation is important. Because, eventually if exchange rate is fluctuating eventually exchange rate is volatile. Investors, consumers cannot make decisions about investment and about consumption. A lot of people, including educated people, think that exchange rate matters only to people who trade, who invest, who have credit in foreign currencies, or who are externally linked. That for the last majority of us who live in the domestic economy, the exchange rate does not matter. That is a mistaken impression. The exchange rate matters to all of us.

You just take the price of oil for example. If the exchange rate depreciates, the price of oil goes up and when the price of oil goes up price of virtually every other commodity, price of every other item in the market goes up. So, the exchange rate matters to all of us. And the stable exchange rate is important for people to make consumption and investment decisions.

What is the RBI policy in managing the exchange rate?

The RBI policy as they said today, as I have said several times as Governor, is that we want a steady exchange rate. We do not target the fixed exchange rate; we do not target a specific exchange rate. We intervene in the market only to curb volatility, not to target a specific exchange rate. But, for the markets, for investors, even for consumers, for borrowers, it is very difficult to make any decisions based on RBI's policy as it is enunciated and as it is practiced.

Because, what is volatility is not strictly defined. Sometimes RBI intervenes when exchange rate is moving in one direction. An exchange rate moving in one direction cannot certainly be defined as volatility for RBI's limits. RBI is not unique; several Central banks need to be. So, there is a responsibility, an obligation on the Central bank to ensure that they take particular decisions based on exchange rate have some way of understanding RBI's policy and in some way of predicting RBI's policy.

Let me make a comment on RBI exchange rate dilemma today because it illustrates in some sense the challenge of maintaining a stable exchange rate, which is important for reaching \$5 trillion. The rupee depreciated by about 11 to 12 percent in the last one year. That depreciation we know is on account of two factors, a widely current account deficit largely because of high pressure for it, and second, capital outflows engineered by tightened financial conditions, high interest rates in Europe, in the U.S. particularly in the U.S.

RBI so far spent about 100 billion dollars defending the exchange rate. It is true that the exchange rate depreciation that we have seen of the rupee over the last one year is largely because of external factors, not so much because of domestic vulnerabilities. But even so, exchange rate depreciation, particularly against the dollar has causes and consequences for our economy. So, even if the

depreciation is a consequence of global factors, the consequences are local; and therefore, it matters quite a lot.

Over the last six months, the price of oil has fallen. But that does not mean that there is a bit relief on the rupee front as we have seen, in fact, the rupee continued to depreciate. And I believe that the rupee remains vulnerable because our current account deficit this year is going to be above three percent, above what RBI believes is a safe limit. Our fiscal deficit, even if we meet the budgeted targets, both at the Centre and State levels, is still quite high. And our reserves are high but if you see some International norms, they have actually declined quite a lot over the last six months and market perceptions about the level of reserves or the adequacy of reserves to defend the exchange rate, market perceptions about the ability of the reserves to defend the exchange rate are shaped not just by the level of reserves but also about how rapidly they are coming down, the burn rate as it burns.

So, as much as there is some relief on a relative basis, on the exchange rate front, I believe we continue to be vulnerable. And there is some case for the RBI to allow the rupee to depreciate; because it will increase the competitiveness. Of course, it'll be inflationary but depreciating exchange rate is also expansion. So, we should take care of inflation through monetary policy and allow the exchange rate to follow the fundamentals; not depreciate the exchange rate or the fundamentals but allow the exchange rate to track the fundamentals, so that our competitiveness improves. The point is, RBI should engineer the trajectory of the fall, not the level to which the rupee falls. So, as I leave this point, maintaining a stable exchange rate is one of the important challenges on a path to a \$5 trillion economy.


The fifth challenge on my list is quite familiar, predictable, which is the importance of being earnest about fiscal responsibility.


**Macroeconomic Challenges on the
Path to a \$5 Trillion Economy**


5th Challenge

**The Importance of being Earnest about
Fiscal Responsibility**

- Fiscal pressures during the pandemic – the responsibility to protect the vulnerable
- Why is a high fiscal deficit bad?
- Is our public debt sustainable?
- What matters is combined fiscal deficit of centre and states
- Freebies – yes, but be responsible.

 BR SHENOY
MEMORIAL LECTURE
2022

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Ideas for a market economy

We have seen two years ago, at the depth of the pandemic, enormous pressure on the Central Government, on all the State Governments, to provide fiscal support to millions of people who

became vulnerable on account of the pandemic.

We saw on our TV screens hundreds of millions of people trudging across the hinterland of the country in the hot summer, May - June 2020. There was pressure on Governments. In the event, the Central Government and the State Governments provided stimulus, but we could not provide obviously as much as the U.S. or Europe. The U.S. threw the kitchen sink at the problem, Europe did that too.

We could not afford to do it just because we are an emerging economy, and we have to mind of fiscal prudence if only because markets are less forgiving of fiscal excesses by emerging economies while they are forgiving of fiscal excesses by rich countries. After all, America, Europe, they borrow in currencies that other countries create, we borrow in emerging economy currencies, which are not our currencies. So, we need to be mindful.

Paul Krugman said in one of his books that the Asian crisis in end of 1990s was because of the pile up of pressure in the East Asian economies.

Australia also had similar pressures. The markets allowed Australia to make a smooth adjustment and avert the crisis. The markets did not allow the East Asian economies to make that adjustment and landed them in a deep protracted devastating crisis. So, markets are less forgiving of excesses by emerging economies.

Why is a high fiscal deficit bad?

A high fiscal deficit is bad, we know for obvious reasons - crowds out private investment, it also raises interest payments of the Government, State and Central Governments, which means that expenditure available for other needs is that much reduced. It pressures inflation and importantly, fiscal excess can spill over into the external sector.

Remember, the 1991 BoP crisis that I talked about earlier and the 2000 near crisis when I was the Governor, when we had a rupee pressure during taper tantrum were both causes at the structural level because of accumulated fiscal deficit and fiscal profligation.

One concern today is, is a public debt sustainable? The FRBM Committee said that a sustainable debt level for India is 60% of GDP; 40% at the Centre level and 20% at State level and 60% overall. Our debt GDP level in 2020 before we entered the crisis was around 70%. Because of all the borrowing during the crisis went up as high as 90%. It has probably come down to 85 or 87%. That is a problem because higher the debt, higher the interest payments and that much less for other expenditure and higher the possibility of getting into debt pressures and eventually into a debt trap.

A lot of people say that India need not worry because we borrow in our domestic currency unlike other emerging economies, where sovereign aid is exposed to foreign currencies in a large way. The sovereign exposure to foreign currencies in India is quite limited, which is of course a safeguard. But I want to say that it did not protect us in the past and we cannot depend on that to protect us in the future.

People also say that debt GDP ratio is low. They said, look at Japan, debt GDP is 300%. In Europe several countries have debt GDP of over 100%. So, why should we worry about debt GDP, 90% is going to come down to 80% . We need to worry because our Revenue to GDP ratio is also low. So, we can get into a debt trap or a debt pressure at a much lower debt to GDP ratio.

I also want to flag this, which is that, what matters is the combined fiscal deficit of the Centre and States. We usually, the commentators, the economists, markets, media, talk about the fiscal deficit of the Centre. Fiscal deficits of the States are equally important because what matters for our stability, for our growth, is the combined fiscal deficit of the Centre and States. And that's important.

Finally, a comment on freebies, which is I believe an important debate we must have. The Prime Minister, two months ago made a comment on the *Revdi* culture, about how Governments are increasingly indulging in giving freebies and thereby jeopardizing the integrity of public finances.

I believe every Government across the country, both the Central and State Governments, every major political party is responsible for this. It is not fair; it is not responsible to point fingers at a specific Government or a specific party. Everybody is in some sense responsible.

I grant that giving some safe thoughts, some safety nets, to the most vulnerable segments of the population is not only necessary or desirable, it is an obligation. But there must be a limit. It cannot be the case that Governments jettison other expenditure that provides the growth potential for the future and use that money for spending on freebies, which is current consumption. We cannot sacrifice future growth for the sake of current consumption. Because, if we do that especially because the Finance Minister pointed out about three days ago, freebies are being financed out of debt.

So, if we use, we borrow money today, spend it on freebies, which is consumption, the burden of repayment will pass on to our children's generation and we don't want to do that as parents and grandparents, we don't want to shift the burden of repayment for our consumption to our children, our grandchildren. So, Freebies - Yes - But within limits.

The second last challenge on my list is financial stability.

Macroeconomic Challenges on the Path to a \$5 Trillion Economy

6th Challenge
Maintain Financial Stability

- What is financial stability and why is it important?
- Several episodes of financial instability in the last 15 years
- Building buffers for financial stability
- The regulator's challenge: growth vs. stability

 BR SHENVOY
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Financial stability is very difficult to define, but we all understand financial instability. We experienced that during the global financial crisis, we experienced that during the Eurozone sovereign debt crisis, we experienced that in 2015 with China introduced to

step back its exchange rate, there were tremors across financial markets. There was instability in India here. We experienced that during the Covid pandemic. We experienced that when several banks in India came under pressure - Lakshmi Vilas Bank, PNB, IL&FS, a prominent a non-finance banking company. So, financial stability is very important for accelerating growth rate and reaching 5 trillion.

The way to achieve financial stability is to build buffers. What are buffers? Buffers are to make our financial markets, our financial institutions strong enough to withstand pressure.

For example, how do we make our banks strong? We make our banks strong by ensuring that they hold adequate capital. And there are norms, which go under the banner of Basel 3 Norms, which RBI follows to ensure that banks, non-banking finance companies including microfinance companies are holding enough capital as a buffer.

The other buffers are macroprudential buffers. For example, when I was Governor, there was concerns about the lending being done by gold loan companies. A lot of people were borrowing and a bunch of gold loan companies were lending. There were concerns about what might happen if the price of gold fluctuates. And because these gold loan companies are in some sense linked to the banks, gold loan companies come under pressure, banks come under pressure. So, we imposed certain norms on gold loan companies during my tenure as Governor. So, macroprudential measures of that sort are buffers.

To maintain or preserve a stable exchange rate, we maintain foreign exchange reserves. We impose certain capital controls. Such as, for example, how much a corporate can borrow, under what terms in foreign currencies. So, these are all

buffers that we introduce in order to maintain financial stability. But the challenge for regulators, the challenge for Governments in maintaining financial stability is to manage sustention between growth and stability.

It is of course possible for the RBI to absolutely ensure financial stability by keeping an absolute Draconian check on facts. But if RBI does that, banks cannot lend. Banks will not do any business, and financial activity will come to a standstill; that is giving an extreme example. So, RBI will have to regulate banks to ensure that they are behaving and they are conducting business in a prudential way, but not strangle them so much that it strangles innovation.

It is like bringing up a child. How do you teach swimming to a child? If you put the child in a swimming pool and all the time holding the child, this child will never learn to swim. You got to let go at some time. You got to decide the precise point of time at which you want to let go. That is judgment call that regulators today have to make in managing financial stability and ensuring at the same time that growth is actually there.

Macroeconomic Challenges on the Path to a \$5 Trillion Economy

**7th Challenge
Create Jobs**

- Unemployment problem is explosive
- Demographic dividend?
- Where are jobs going to come from?
- Can India replicate the China model of manufacturing growth?

The final challenge on my list, possibly the most important, is creating jobs; because the unemployment problem today is possibly the most crucial problem facing the economy.

About 12 million people join the labour force every year. We are not even able to provide half as

many jobs or create half as many jobs. So, the jobs that we are creating are low productivity jobs in the unorganized sector.

Someone told me that the largest number of jobs created over the last three years is of security guards'. Now, you all understand what a low productivity job of security guard's is. So, we need to create productive jobs.

People talk about a demographic dividend. You know, 25 years ago or 20 years ago, we used to treat our high population as a problem, as a pressure, as a burden. But, over the last 10 years the narrative has changed. We now think of our population as a positive. Especially, if you contrast our population with that of other countries, advanced countries, as well as some emerging economies.

Japan is seeing a decline in population. Some Scandinavian countries are seeing the populations decline. Europe, mainly large economies in Europe, population growth rate is stabilizing. U.S. is getting there. China is worried about the ageing population. China is worried that it will get old before it gets rich.

India is contrary to that trend; the median age is 29. So, we have a huge labour force. People say that this labour force will join, they will earn, they will save, when they save that turn into investment, which will turn into production, which will turn into jobs, which will turn into growth and we will get on to virtuosity.

But this will happen only if you are able to provide the jobs. The critical leg to exploiting the demographic dividend is to provide jobs. It is a very, very difficult challenge. It is by no means my intention to minimize the enormity of the challenge of providing jobs. But nevertheless, I thought I should flag this.

Where are jobs going to come from? They are not going to come from agriculture. If, in fact, agriculture productivity goes up as we wanted to,

agriculture will unleash about 75 million people probably 100 million people who are underemployed in the agriculture sector and these 100 million people are not skilled. So, we got to generate low and semi-skilled jobs in order to provide jobs to these people.

Agriculture is not good to provide jobs. The services sector is certainly not able to provide jobs of the type we need.

Now, for those of us who travelled abroad, people say, India you know, Hyderabad, Bangalore, Pune, Gurgaon jobs, you know, are exploding. They see the minuscule of the software sector. But, that's just a very, very small part of a services industry. The services jobs will come only if manufacturing jobs come. So, we got to depend on the manufacturing sector for jobs.

The last question on this jobs front is, whether we can replicate the China model of manufacturing growth. This is very important and because this is something that's debated in policy think-tanks along the world, particularly in India, in the media etc., whether India can replicate a China model of manufacturing growth.

The argument made is that it is difficult for India to do that; because when China opened in 1980, the world was acceptable, open to globalization. Globalization was seen as a benign force. The global value changed for gaining prominence as a preferred mode of manufacturing, transport costs were coming down. So, it was possible for China to become the hub of manufacturing, produced there and export to rest of the world. Because of the benign attitude to globalization, because of productivity improvement in China and because of other factors - is not possible for India, it is argued - to replicate that experience in 2030s, because the world attitude to globalization is hostile, if not very

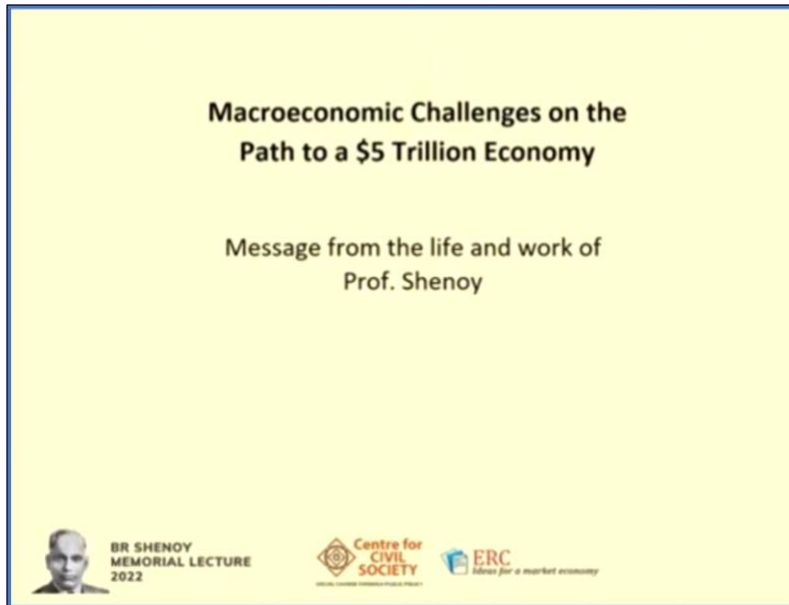
hostile today. So, we cannot manufacture, we cannot become a manufacturing hub like China.

The global value chain, which has been the defining characteristic of China model is losing its prominence. Now we are talking about nearshoring and offshoring, artificial intelligence, machine learning, are changing comparative advantages become impossible for rich economies which earlier outsourced production to insource it now. So, people say India cannot replicate the China model.

But I have a slightly different view. I believe that it is still possible for India to manufacture for the domestic economy and for export; just because our domestic market is very large and because our share in global exports is very small. So, it should be possible for us to double our export share by improving our productivity even if the global export market does not expand. So, all I want to say is that as much as there is some merit in the argument that India may not be able to replicate the China model of manufacturing growth, we should not altogether give up on manufacturing. There is still a lot of potential and indeed it will be difficult to provide the hundreds of millions jobs that we need without manufacturing, particularly, without emphasis on small and medium enterprises.

That brings me to the end of the seven challenges. It is just a listing of the seven challenges for your takeaway.

And what I want to say finally is that if you want to grow, accelerate growth, get to 5 trillion. As I said, we need growth with widely shared prosperity. And



as much as all the challenges that I have listed are important. Indeed, all of you in the audience can expand that list of challenges. But the attitude which you should take to our economic management is to be open to ideas; to

challenge conventional economic orthodoxy, to respect dissent, and to be pluralistic in our economic management, in our political management. And that's where I believe the life and work of Dr Shenoy is a shining example for guiding today's economic management.

I will stop there. Thank you very much.

Shri Kumar Anand:

Thank you very much sir for that very illuminating talk.

We have a lot of questions from the audience and some I have received in text.

So, what I will try and do is, if the questions are of similar nature I'll try and club them. So, maybe a few of the questions can be bundled and more questions can be taken that way.

The first question comes on the topic that you talked about last, which is about Jobs, just broadly clubbing.

Ms Shruti Ashokan asked, Sir, China's growth model relied on manufacturing and export. However, India is a service-led economy and recently Mr

Raghuram Rajan said that India cannot follow China's path. I would like to know your opinion on this.

*Shri **Shourya** has asked a similar question - On the need to ensure productive jobs has the MGNREGA Policy overstayed its use and require a complete overhaul? So, what according to you should be the role of Government and the RBI, if any, when it comes to creating jobs?*

*And just one more to club this entire thing and get the job thing sorted out of the way, one question is from Shri **Rajesh Jain** and he asked - How can India create 100 million jobs good jobs in the next five years, a good paying job something like 40,000-50000 rupees a month that offers upward mobility. And what are the hurdles that need to be removed, this against the backdrop of War, inflation etc that you talked about. So, overall, I think it's about jobs and what model to apply.*

The short answer is, I have no answers because these are tough questions, I tried to address them in part during my talk. But nevertheless, I will try and address some of these.

I know that Prof Rajan has spoken about focusing on services for the future. It is not for the faint-hearted context what Dr Rajan said and I agree with him, which is that we must focus on services for tomorrow's growth indeed for today's growth. But at the same time, I believe that we cannot de-emphasize manufacturing. For the simple reason that we still have to depend on manufacturing to provide tens of millions, indeed hundreds of millions of jobs we need. And I believe in the short-term; when I mean short-term I mean medium-term.

In the next 15 years as much as India will have to mobilize jobs from the services sector, I believe there is potential even in the manufacturing sector.

There is some manufacturing pessimism of people like Mr Arvind Subramaniam's talk about premature industrialization, or some phrase that is, which is to say that India cannot rise to the level of industrialization of other developed countries. We have to move on even before that. But I believe there is scope. Number one, because we have a large domestic market. With people at low and low-middle income level, we can manufacture domestically for that. Just look at this. We import as much as 100 billion of low-cost consumer goods from China. 100 billion!

Even if you can make 50 billion out of that within the country, we can create so many jobs. So, I don't believe that we should de-emphasize manufacturing as much as that. Again, something that I said during my talk, yes, the global export market may not expand, in fact, it might even contract.

But India's share in the global market is so small that it should be possible for us to double our share in the global market even if the global market is itself not expanding.

That is my response to Ashokan's question.

On the question of MGNREGA, you know, I must admit that I have no first-hand exposure to MGNREGA. It is designed with a lot of expectation. And I believe it did deliver quite importantly during the pandemic, when women and a lot of men who came back from their urban employment, back to their villages, took advantage of MGNREGA. It became a lifeline and I think the Government actually replenished the budget for MGNREGA.

See, in an ideal world, we want nobody accessing MGNREGA, right? That's the ideal situation, because MGNREGA is supposed to be a safety net, a fallback option. So, in an ideal world, we do not want people coming into MGNREGA. But, we should not design it so tightly that it becomes difficult for

people. In fact, this morning I was debating with some people about how MGNREGA is gender biased. You know, one of the things in India is that, I am going astray a little bit but it's important to the debate; one of the things happening in India is that female labour force participation ratio, FLPR is coming down; not just low, but coming down. And that hurts growth. And why are women withdrawing from the labour force? That is a very very tricky question and an important question.

On the question of MGNREGA, there is an important positive gender bias for women. MGNREGA mandates that employment should be provided within a five-kilometre radius, and that is to provide employment to women who cannot move very far away from villages. So, I think we should look at MGNREGA, look at some studies, about how it operative it has been, how efficient it's been. Okay?

Rajesh Jain's question about how we can create 100 million jobs, I have you know I cannot say any more than I've said. But I believe that we should focus on Skilling. Skilling people of coming out of agriculture. We should focus on improving productivity, we should focus on skilling of women particularly. We should focus on raising wages for labour, for women; because one of the reasons women have been withdrawing from the labour force, I believe, is because they are not willing to labour at the current wage level. So, we must raise the base levels for them. And we should focus on medium and small industry, which means more employment incentives. Thank you.

Prof Kumar Anand:

Thank you Sir. There is one question from Mr Anirudh Dutta. It is slightly outside our conversation subject today. He asked – Can you please speak a little bit about the two challenges, institutional and governance?

Dr Subbarao:

Anirudh, thank you for that question. The governance challenge is something that I did. I said, you know, I talked about how the Chinese investors had come and how we failed to deliver on our promises. I can give you another illustration.

When I used to work in the State Government in Andhra Pradesh, 30 years ago in Government of India, a lot of investors used to come. We used to go around. Even today, Chief ministers, Finance ministers, go around the country, around the world, scouting for investors and they offer incentives, you know, freebies etc. They say they will give you utilities, concessional rate of electricity, land we will provide, etc., etc. But if you ask investors privately - what is important to you? They will say - We will take all these freebies that you're giving, we will take all the concessions you are giving, but what is more important to us is that you free us from your inspections, from your inspectors. So, this is a big governance problem and institutional. Actually, now I support institutional and governance challenges together.

Some of you might have read Francis Fukuyama's book, I think it is called - *Trust: The Social Virtue and the Creation of Prosperity*, and the other one was called *State-Building: Governance and World Order in the 21st Century* - Fukuyama actually studied development history and he says that what characterises developed societies are three things - rule of law, accountability and a strong State.

So, Anirudh, ask yourself, where do institutions in India stand on this - on accountability, on the rule of law, and on a strong State. You know, I actually sometimes ask myself, can I add to Fukuyama's list? And I think all of you

should ask yourself, whether you can add to Fukuyama's list, challenge the proposition. I would say that we all are institutionally bound across the country in order to grow harmoniously to a \$5 trillion economy. So, institutional challenges, governance challenges and political challenges.

Prof Kumar Anand:

Thank you Sir, the next question is from Shri Samruddha, and he invokes an essay by BR Shenoy. He says, BR Shenoy in his famous essay called "My Idea of a Welfare State" wrote that "true welfare lies in individuals being able to meet their own idea of their welfare goals, and the State only has a role in maintaining the rule of law". So, would not goal setting like five trillion-dollar economy reduce the scope for individuals to decide what is true welfare for them?

Dr Subbarao:

Samruddha, I can answer that at an economic level, at an economist level, I cannot answer it in the philosophical level, I certainly cannot answer it as well as Prof Shenoy would have answered it. But you know, as Adam Smith said, there is really no conflict in a free market society between individual interest and collective interest. After all what did Adam Smith say? That if people behave selfishly the butcher and the baker, if they actually selfishly, self-centredly, working for their own livelihood, they are actually collectively contributing to collective welfare. But of course, we cannot have such a free market society without any constraints because we live together, we need to have some norms we need to have some regulations.

So, I think it's important for individuals, households, communities, societies, to be able to decide on their own welfare norms. But, keeping in view the fact that their interests, their welfare norms, should not infringe on others, because that's

the whole idea of living responsibly in a welfare society but in a growing economy. So, I would think that the State has a role, maybe the State will not wither away like Marx said, the State will continue to have a role, but I think individuals should have the freedom to decide their own welfare goals.

I mean everybody wants a certain level of income, certain quality of life, but beyond that how they spend their money, how they enjoy their welfare, should be left to them.

Prof Kumar Anand:

Thank you Sir. Next question is from Shri Mohit Satyanand and he asked where are the savings for growth; like you said that savings is missing in the investment story, which is the most important thing. So, where are the savings for growth? This is the question.

Dr Subbarao:

Savings are there in the economy. Savings will come with interest rate for some. Savings will not come out of thin air, they will not fall from the sky, people will save and will put that in Banks which will turn into investment. Of course, savings will come from higher incomes. I don't want to belittle Mohit's question, which is that, the income should go up, people should consume more, people should also save more, and they will save more if interest rates are attractive. So, we should ensure that consumption levels go up. We should also ensure that people are encouraged to save.

Prof Kumar Anand:

Thank you, there are many questions regarding rupee and the exchange rate. So, even clubbing them is difficult because they are in different directions and

clubbing them will also be a challenge, but I'll try. So, the question is, about six months ago rupee was 78 but RBI tried to defend the currency and it is currently now at 82. So, in retrospect would it have been better if RBI didn't try to defend the currency?

In the same way, Shri Giridhar Prabhu asks this question, Professor Shenoy mentioned that equilibrium value of the rupee has not been arrived at since 1936, when it was totally free. So, how could we get into determining it now?

Dr Subbarao:

You know both are difficult questions to somebody outside the RBI. As said in my talk that the RBI should not try to defend the exchange rate against fundamentals. If the value determined by the fundamentals is at 82 rupees to a dollar, I think it'll be futile for each Central Bank to try and defend that.

What RBI can do and indeed has done is to engineer the trajectory of the fall. If indeed, RBI did not intervene it's quite possible that the fall would have been much more volatile, hurting the economy. So, I would not say that RBI intervention has been completely futile. In fact, I believe it had positive impact in terms of reducing or containing volatility. But, the general principle is that there is a cost to intervention. There is a cost to maintaining reserves and there is a cost for trying to defend the rupee against fundamentals because eventually it'll come down no matter that you're trying to defend it. So, it is a judgment call that the RBI management in consultation with the Government will have to take on.

On Mr Giridhar Prabhu's question about the Prof Shenoy's equilibrium value, I think 1936 he said that's when equilibrium value when we were perhaps operating in a free market system. Today the equilibrium value is seen as the

Real Effective Exchange Rate – REER, which is the exchange rate of the rupee against 40 trading partners weighted average effective exchange rate against the rupee - against the currencies the 40 of our trading partners on a weighted basis.

I don't believe that RBI tries to track the REER. You know, it is quite possible that the rupee in nominal terms is quite stable although REER is not 100. Even if REER is not 100, rupee can be quite stable. But, REER can be a guide for RBI to see where the exchange rate might be going or where the exchange rate has to go. I don't think the nominal exchange rate has to be in complete equilibrium with the real effective exchange rate but the REER can be a guide.

Prof Kumar Anand:

Thank you Sir the next question is somewhat about data in general. So, Shri Amit Chandra asked this question about the reliability of data and information. That if data is manipulated or not completely reliable then anything could be achieved on paper and would be meaningless.

And in similar way Shri Srinivas Iyengar asked that, to identify why there is a disparity between jobs data and EPFO data. So, the EPFO shows healthy growth in numbers each month, however the jobs data from various public and private sources presents a pessimistic picture. So, any thoughts on this dichotomy?

Dr Subbarao:

Thank you, first on Amit Chandra's question, of course, Economic Policy making depends heavily on data and reliable timely data is very critical. During my time we had wrong footage several times; because of faulty data, because of revisions to data. In fact, we should have cut into States sooner if we had known that growth actually did not decline as much as it did. But, you know, whatever

reason we did not get right data in the right time and therefore Economic Policy was wrong footed.

But, over the last 10 years, I believe that our quality of data has improved; the timeliness of data has improved. There are of course, some speculation that the data released is becoming a matter of convenience - matter of political convenience. I have no way of affirming or contradicting that, I see what others are seeing. But, for the credibility of the Government, for the Central Bank indeed, for public institutions, it is important that we release data, and in time. Because, the market and the larger economy is entitled to have the same data on which the policy makers are basing their policy. So that, data integrity and data disclosure integrity has improved.

On Mr Srinivas Iyengar's question about the disparity between EPFO jobs data view, but you know, I have heard something about job surveys. They ask people about how long, how many days did you work? In the last one month, in the last one year, jobs data depends very critically on the recall value of people. And recall value tends to dissipate over time, tends to dissipate if people are idle. So, quality of data depends on the quality of responses. But, I have no specific response to the disparity between EPFO and jobs data.

Prof Kumar Anand:

Thank you Sir. Shri Giridhar Prabhu asks a question about a topic which has been a topic of a conversation for a long time, but lately not so much. He asks, Sir, you have closely looked at Tarapur Committee in 1998 and 2001 - recommendation on capital account convertibility. So, we can now be Bankers to the world; but why this hesitation towards capital account convertibility?

Dr Subbarao:

I'm aware of the Tarapur Committee recommendations, but I'm also aware of the new experience that capital account convertibility is not necessarily the end point. Let me clarify myself, just so that I'm not misinterpreted, which is that 10 years ago, the IMF usually evangelized what we used to believe that we had to go forward on the path to capital account convertibility and the ultimate Nirvana is complete convertibility that rupee will become a hard currency.

Now, we know that in a financially globalized world it is not necessary that the end point has to be complete capital convertibility. Because, a lot of stability depends on capital flows. Of course, we need to progress on the path to capital account convertibility. But, we should keep track of our economic situation.

Today, for example, we still have high fiscal deficits. Our banks are not completely resilient. Our financial markets are not deep enough. Our financial markets are obviously not enough. So, we got to move along the path of capital account convertibility in harmony with the resilience of our financial institutions, under financial markets. And, I believe that we will move forward. But, as I say often, we will make haste slowly. That is a '*festina lente*', we call it in Latin, which in English is '*we will make haste slowly*'.

Prof Kumar Anand:

Thank you Sir, I will use the privilege of being the moderator and ask a question myself. This relates to one of the conferences I was at; and the most hotly debated topic was about the sharing of the GST pool, the resources - the fiscal resources between States. And you know, the claim is made that some of the poorer States are being rewarded and are getting a bigger share compared to, say, southern States, which are richer. And that debate you keep seeing in the media quite often.

Where do you see that debate going and what would be the appropriate response particularly from a fiscal point of view, finance commission particularly?

Dr Subbarao:

Thank you for that question. I have thought about it. I have to answer this but I'm not much into the GST debate. But the GST is a national product. Both the Centre and States collectively have locked a gain. There is some give and take because we moved from an end point Sales Tax to VAT, and now to GST. So, some States benefit, some States are cross subsidizing policies. But eventually, I believe that a rising tide will lift all boats and will lift all boats equally.

So, we are still in a transition on the GST and therefore there might be some disparities. Some heartburning, some cross subsidization, some of it is transparent, some of it is not transparent, but it is inevitable in every Federation. It is not unique to India. You see, this in rich countries as well, you see this in the U.S.

President Clinton often used to say that Arkansas, the State that he came from was one of the poorest. He used to argue for more to Arkansas. It happened in Australia, it happened in Sri Lanka, it happened in African countries such as Ethiopia. So, interstate tensions about resource sharing are not unique to India. They are in every Federation. East Timor, separated from Indonesia mainly because of this issue of resource sharing. And in India I think we've managed our Centre-State relations on the fiscal dimension, quite well I would say. The Finance Commission has commanded a lot of respect because their recommendations have been quite balanced. And, you cannot satisfy everyone.

Richer States have an obligation to come to the support of the poorer States but poorer States should not build a vested interest in remaining poor. So, that's a difficult political judgment. I believe we have the institutions of Centre-State federalism in particular the Finance Commission to manage this.

Prof Kumar Anand:

Thank you, Sir. The scheduled time is just about over but we have some remaining questions. So, depending upon if you have some time available maybe you can continue or we can close up.

Dr Subbarao:

It's up to you. I have ten minutes more.

Prof Kumar Anand

Okay, great! So, then we will take a few more questions before we do the conclusion remarks.

The next question is from Shri Mansa. And Mansa asks, can India pave a new model of growth if it can implement agriculture reforms and increase its productivity and exports instead of focusing on manufacturing alone in context of increasing protectionism across the world?

Dr Subbarao:

Yeah, I think there are a lot of weight in what Mansa asked. You know, because the traditional textbook development model is that the traditional economies are heavily into agriculture and the primary sector. They move from agriculture to the secondary sector, mainly manufacturing. Then they move to the services sector and they become post-industrial societies. That is the traditional model.

For much of the 1990s including the early years of this millennium, we used to take pride in the fact that India defied the traditional model.

We leapfrogged over the manufacturing sector, we moved directly from agriculture to services. Our services sector as a proportion of the GDP is much larger than most other developing countries, at this level of per capita income. So, India has struck a new path. But that reality has come to hit us now. Now we know the importance of manufacturing for jobs. And I've already explained my views on the importance of manufacturing for jobs.

But, my question is, can we instead focus on services? My point is that these are not mutually exclusive - services and manufacturing - emphasis on services and manufacturing are mutually exclusive.

In fact, I can say even this that it might be difficult to develop a service base without a manufacturing base. A lot of experience shows that services come on the back of manufacturing growth. So, in striking up a new path we must of course see if there's a new path there, a new model there. But, we must not jettison accumulate experience just to experiment, to conduct a very critically important big experiment. The cost can be very high.

Prof Kumar Anand:

Thank you , Sir. We will take one last question before we conclude. Ms Bhavya Mehta asked this question, in context of buffers for ensuring financial stability, how should our country design buffers for extreme situations such as a massive lockdown affecting multiple economies at a time as seen in the Covid-19 pandemic. So, any guiding points or things to keep in mind?

Dr Subbarao:

You know that question at the national level how resilient should the buffers be can be translated to a question at a personal level, at a household level.

How much insurance would you buy? Because you can insure your property, you can insure quality of life and insure your family you can insure your life for an exorbitant amount but that will also cost an exorbitant amount.

So, you're all the time trying to balance between the amount of insurance you want and the amount you have to pay for that insurance. It is the same thing about buffers for an extreme situation. You know, take for example, how much of food grains should we have - because it costs a lot, you know food grains and food grains erodes over time, their cost to holding foreign exchange reserves.

So, how much of food grains, how much of foreign exchange reserves, how much of buffers should we hold? In fact, it is the cost to asking banks to hold capital.

Of course, RBI can ask Banks to a 50% capital but banks have become so unprofitable that there would be no credit for it. So, there is always this judgment that individuals outsource communities, societies, countries , have to make between what insurance will we buy and at what cost.

Prof Kumar Anand:

Thank you very much, Sir. I'm reminded of a particular quote which I want to share, Milton Friedman, writing about Dr Shenoy's Note of Dissent on the Second Five-Year Plan.

Friedman says if one reads Shenoy's report now and he's writing in 1963 you know, his report sounds like a retrospective description of what happened

rather than a forecast. So, I'm hoping that all the challenges that you have laid down, you know, and some of them are quite something to keep in mind, especially that how the economic growth should not be working for a few but for all and keeping the 10-year-old girl in mind.

So, I'm hoping that we overcome those challenges soon. With that this brings to a close of the Annual BR Shenoy Memorial Lecture 2022 and on behalf of Economic Research Centre, Mangalore and Centre for Civil Society, New Delhi I would like to thank our speaker Dr Subbarao for such an illuminating talk and engaging with questions from the audience.

Many thanks also to Shourya and the rest of the team at CCS for helping organize this lecture. Thank you very much Sir and thank you everyone for joining us. Thank you. Good night.

Dr Subbarao:

Thank you Kumar, thanks everyone.

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\* The above is the output of transcribing from the recording of the event uploaded on You Tube. Although the transcription is largely accurate, in some cases it might be inaccurate due to audio disturbance.

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