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# Macroeconomic policy, employment and decent work in India

C. P. Chandrasekhar

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# Preface

The primary goal of the ILO is to work with member States towards achieving full and productive employment and decent work for all. This goal is elaborated in the ILO Declaration 2008 on *Social Justice for a Fair Globalization*,[1] which has been widely adopted by the international community. Comprehensive and integrated perspectives to achieve this goal are embedded in the Employment Policy Convention of 1964 (No. 122), the *Global Employment Agenda* (2003) and – in response to the 2008 global economic crisis – the *Global Jobs Pact* (2009) and the conclusions of the *Recurrent Discussion Reports on Employment* (2010 and 2014).

The Employment Policy Department (EMPLOYMENT) is engaged in global advocacy and in supporting member States in placing more and better jobs at the center of economic and social policies and growth and development strategies. Policy research and knowledge generation and dissemination are essential components of the Employment Policy Department's activities. The resulting publications include books, country policy reviews, policy and research briefs, and working papers.[2]

The *Employment Policy Working Paper* series is designed to disseminate the main findings of research on a broad range of topics undertaken by the branches of the Department. The working papers are intended to encourage the exchange of ideas and to stimulate debate. The views expressed within them are the responsibility of the authors and do not necessarily represent those of the ILO.

Azita Berar Awad
Director
Employment Policy Department

[1] See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf
[2] See http://www.ilo.org/employment.

# Foreword

The slow and uneven pace of economic and employment recovery since the 2008 global financial crisis highlights the need to reconsider macroeconomic policy thinking. There is a need for policy to be more pro-employment to ensure fast, inclusive and sustainable economic growth. This is especially important for emerging and developing economies striving to escape the “low-” and “middle-income” traps, and achieve the Sustainable Development Goals (SDGs), especially Goal 8 “to promote inclusive and sustainable economic growth, employment and decent work for all”.

The International Labour Organization (ILO) has been working on pro-employment macroeconomic policies for a number years, assisting member States’ efforts towards decent work and productive employment for all. Constituents asked the ILO to identify promising macroeconomic policy frameworks, notably in the 2003 *Global Employment Agenda*, the 2008 *ILO Declaration on Social Justice for a Fair Globalization* and the 2009 *Global Jobs Pact*. More recently, the 2014 International Labour Conference *Conclusions concerning the Second Recurrent Discussion on Employment* specifically called for assistance to policies that “support aggregate demand, productive investment and structural transformation, promote sustainable enterprises, support business confidence, and address growing inequalities” (ILO, 2014: 7(a)).

While India has achieved high economic growth rates in recent years, this has not been matched by equal advances in decent work and employment creation. This study contends that the focus on attaining macroeconomic stability objectives has resulted in insufficient attention to the broader development goals of job-rich and inclusive growth. To remedy the situation while maintaining fiscal and monetary sustainability, the author advocates for: (i) strengthening tax revenue on a progressive basis and (ii) directing government investment towards overcoming key supply-side bottlenecks. This would facilitate employment-creation while reducing inflationary pressure and ensuring fiscal sustainability.

This paper was authored by Professor C. P. Chandrasekhar at the Centre for Economic Studies and Planning at Jawarharlal Nehru University in New Delhi. It was presented and discussed at the *ILO Employment Symposium* held in New Delhi on 15 December 2015.

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# Abstract

This paper examines the recent evolution of fiscal and monetary policy in India since the 1991 economic reforms, along with their impact on employment and decent work outcomes. To achieve macroeconomic stability objectives and attract foreign direct investment (FDI), the Government of India committed itself to reducing the fiscal deficit to 3 per cent of GDP through the Fiscal Responsibility and Budget Management (FRBM) Act, while the Reserve Bank of India (RBI) adopted an inflation-targeting framework with a target of 3 per cent. However, the Government has not been successful in achieving either of these aims, in part due to the largely successful stimulus package enacted in the wake of the 2008-09 global financial crisis. Nevertheless, the paper argues that the continual focus on attaining these macroeconomic stability aims has resulted in limited progress in supporting employment creation or achieving decent work goals. To address these problems, the paper recommends that the Government of India (i) diversify its sources of tax revenue and (ii) use public investment to overcome key supply-side bottlenecks. The latter measure would reduce inflationary pressure and facilitate job creation and the attainment of decent work objectives.

Key words: India, employment policy, labour market policies, macroeconomic policy (fiscal policy, exchange rate policy, monetary policy), tax policy

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## Abbreviations

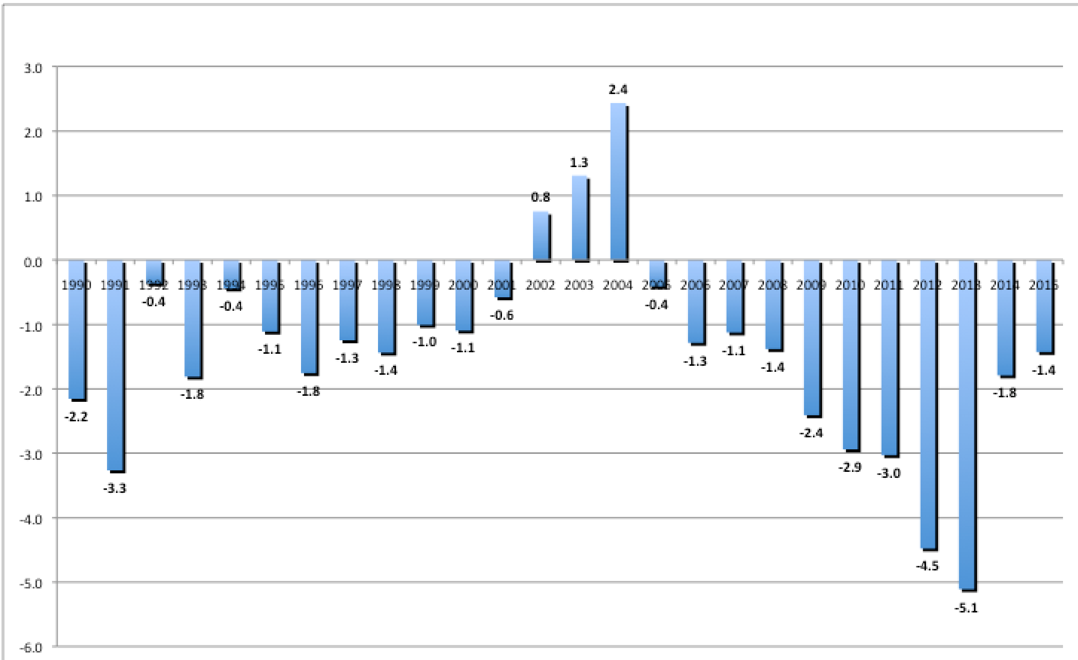
| | |
|---|---|
| CPI | Consumer Price Index |
| CRR | cash reserve ratio |
| DFI | development finance institutions |
| FII | foreign institutional investors |
| FRBM | Fiscal Responsibility and Budget Management acts |
| GDP | gross domestic product |
| GFD | gross fiscal deficit |
| GIC | General Insurance Corporation of India |
| ICICI | Industrial Credit and Investment Corporation of India |
| IDBI | Industrial Development Bank of India |
| IMF | International Monetary Fund |
| IT | information technology |
| INR | Indian rupee |
| LERMS | Liberalized Exchange Rate Management System |
| LIC | Life Insurance Corporation of India |
| MSS | Market Stabilization Scheme (RBI) |
| NDTL | net demand and time liabilities |
| NPA | non-performing asset |
| NRI | non-resident Indians |
| NSS | National Sample Survey (India) |
| OMO | open market operations |
| PPP | public-private partnership |
| RBI | Reserve Bank of India |
| SDR | Special Drawing Rights (IMF) |
| SLR | statutory liquidity ratio |

# 1. Introduction

A consequence of the post-1991 economic restructuring in India has been an emphasis on “sound” macroeconomic policies, involving a combination of fiscal consolidation, central bank independence in the pursuit of monetary policy objectives, and measures to ensure that the effects of policy instruments are transmitted through the system to achieve their intended outcomes. The goals of macroeconomic policy are broadly defined as ensuring a combination of growth, low inflation and a sustainable balance of payments as well as exchange rate stability. The principal agencies or institutions that are seen as responsible for achieving this are the Finance Ministry and the Reserve Bank of India (RBI), India’s central bank.

The RBI itself is concerned less with growth – and associated objectives such as employment generation and poverty alleviation – than with price stability and exchange rate management. While delineating how monetary policy objectives have evolved, an Executive Director of the RBI (Mohanty, 2010) noted that, besides “maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy,” the “progressive liberalization and increasing globalization of the economy” saw the maintenance of “orderly conditions in financial markets” emerge as an additional objective. Essentially, therefore, while the RBI periodically reports on employment and welfare trends in the economy, there is no systematic effort on its part to monitor those variables and seek ways of promoting adequate decent work. Such objectives are left to the Government to pursue through fiscal policy and other means.

**Figure 1. Current account deficit-to-GDP ratio (%) (1990-2015)**



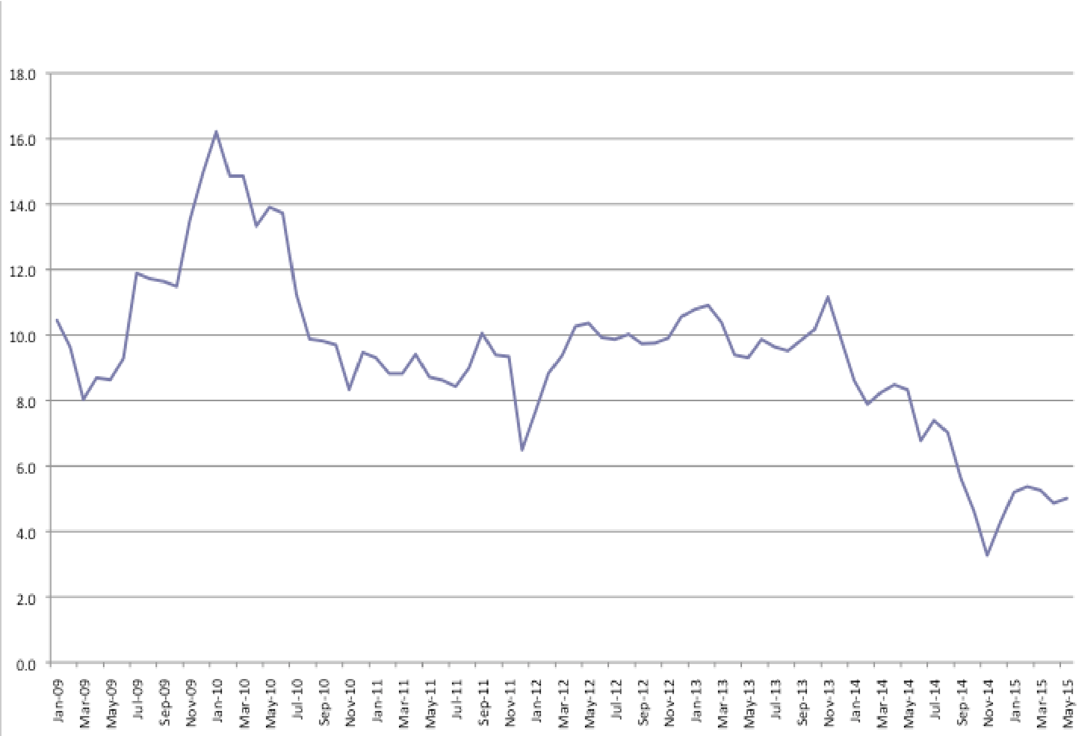

Source: RBI (various issues – a; b).

The problem on the ground has been that simultaneous success with the three macroeconomic objectives of growth, price stability and a sustainable balance of payments has been difficult to achieve. The substantive failure has been the inability to keep the trade and current account deficits on the balance of payments in check, at levels that are reasonable. India has almost consistently been a deficit country. This makes it extremely vulnerable to either unavoidable shocks, such as a spike in international oil prices, or avoidable ones, such as a surge in gold imports. As Figure 1 above shows, the period from

2004-05 has seen a sharp rise in the current account deficit-to-GDP ratio, which peaked at 5.1 per cent in 2012-13. It was only when global oil prices fell sharply and the Government intervened to reduce gold imports that the deficit declined markedly. That decline was also facilitated by the decline in non-oil, non-gold imports as a result of a deceleration in domestic growth. However, the latter did not prove to be a problem because of large net inflows of capital from abroad, especially portfolio capital invested in equity and debt markets.

The other sign of macroeconomic instability in recent years has been the persistence, until very recently, of relatively high inflation. As Figure 2 below shows, the annual month-on-month rate of inflation as measured by the Consumer Price Index (CPI) was above 8 per cent in almost all months between January 2009 and November 2014. It is only more recently that the rate has declined to less than 5 per cent. However, with unseasonal rainfall in 2014-15 having adversely affected food grain production and the deficient rainfall during the main southwest monsoon from June to September 2015, agricultural prices in general, and food grain prices in particular, are expected to rise. That could spell the return of inflation.

**Figure 2. Year-on-year consumer price inflation (Jan. 2009-May 2015)**




Source: CSO (2014a).

India's only macroeconomic "success" is the relatively high rate of GDP growth that it has been able to sustain, though many believe that the new GDP series with 2011-12 as base exaggerates the rate of growth of GDP in recent years. The new figures suggest that GDP in 2013-14 grew at 6.9 per cent as compared with 5.0 per cent computed on the basis of the earlier National Accounts series with 2004-05 as base (CSO, 2014b). Further, between 2012-13 and 2013-14, as compared to a rise in the rate of growth from 4.8 to 5.0 per cent based on the earlier series, the rate rise now takes it from 5.1 to 6.9 per cent. So the year 2013-14, the new figures suggest, was characterized by a smart recovery rather than persisting slow growth. Finally, GDP growth in 2014-15 was placed at a comfortable 7.3 per cent. However, sector-specific indicators of growth in industry and agriculture suggest that growth in the commodity-producing sectors has been decelerating.

Moreover, the impact of growth on employment, poverty reduction and alleviation of social deprivation has been disappointing, despite signs of progress in some areas. This has given rise to criticism that government spending has been inadequate relative to requirements, partly because of the strict adherence to fiscal deficit targets, and that the growth trajectory has not ensured livelihood options sufficient in terms of magnitude and quality to address deprivation to the required degree.

The adherence in more recent years to stringent fiscal deficit targets seems to be motivated by two factors. First, the belief that inflation is India's most important economic problem, given that growth has been high and foreign capital inflows cumulatively well in excess of current account deficits. Hence, the focus of macroeconomic policy has been inflation, with many analysts and a significant number of policy makers calling for both fiscal and monetary policy responses to inflation. Second, the pressure from foreign financial investors, in particular, to rein in deficits to pre-empt macroeconomic instability.

This paper traces the evolution of macroeconomic policy in India, especially over the last three decades. Sections 2 and 3 examine the relative emphasis on fiscal and monetary instruments by identifying the objectives that macroeconomic policy sought to achieve and assessing its efficacy. Section 4 discusses the policy impact in terms of generating adequate and decent employment. Section 5 concludes with policy recommendations to make macroeconomic policy more conducive to inclusive growth and decent job creation.

# 2. Fiscal policy

## 2.1 Overview

Motivated by the factors noted above, the Government (through the Finance Ministry) has renewed its commitment to achieving oft-deferred targets for the fiscal deficit-to-GDP ratio, which is to be brought down to 3 per cent or less so as to ensure fiscal consolidation. Though there were earlier attempts to reform India's fiscal policy framework, the process gathered momentum when, first the Centre, and subsequently the States (of the Indian Union), passed Fiscal Responsibility and Budget Management (FRBM) Acts, that not only set phased, yet stringent, targets for deficit reduction, but also required the Government to report periodically in a transparent fashion on the state of the *fisc*.

The preamble to the FRBM Act states: "An Act to provide for the responsibility of the Central Government to ensure inter-generational equity in fiscal management and long-term macro-economic stability by achieving sufficient revenue surplus and removing fiscal impediments in the effective conduct of monetary policy and prudential debt management consistent with fiscal sustainability through limits on the Central Government borrowings, debt and deficits, greater transparency in fiscal operations of the Central Government and conducting fiscal policy in a medium-term framework." The original Act specifically prescribed that "The Central Government shall take appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by the 31 March 2008 and thereafter build up adequate revenue surplus."

The revenue deficit is still not on target and there have been occasions when the Government has been forced to defer achievement of the targets set by rules framed under the Act, as happened after the global financial crisis. But the existence of the FRBM Act, substantially reduced the Government's room for manoeuvre when it came to the excess of its expenditures over revenues. This was a challenge also because trade liberalization (which required reduction of customs duties), the process of rationalizing the tax structure as part of fiscal reform, and the commitment to facilitating private investment, were setting new limitations on revenue growth.

However, though the annual gross market, borrowing by the Government of India and the State Governments increased from 123 billion Indian rupees (INR) in 1991-92 to INR 7,602 billion in 2013-14 and the amount of outstanding Government of India securities increased from INR 780 billion in 1991-92 to INR 35,141 billion in 2013-14. The public debt-to-GDP ratio declined in the past decade and stood at a relatively low – by international standards – 39 per cent of GDP for the Central Government (49 per cent of GDP for total central government liabilities) in 2013-14. Furthermore, the interest payments-to-revenue receipts ratio of the Central Government declined and stood at 37 per cent in 2013-14, significantly lower than the 51 per cent of 2002-03 (Khan, 2014). This points to a modicum of success in fiscal consolidation.

## 2.2 Recent trends: Ending fiscal dominance

The attempt to reform fiscal policy was driven not only by the need to limit the size of the public debt, so as reduce the burden of interest payments on the budget, but also by the perception that it is necessary to strengthen the monetary lever by reducing fiscal dominance over monetary policy. To that end, the Government of India and the Reserve Bank of India (RBI) entered into an agreement to end the practice of automatically monetizing part of the fiscal deficit by issuing *ad hoc* Treasury Bills that the RBI was required to acquire and hold. Such accommodation was being provided at an interest rate of 4.6 per cent, well below the market rate prevailing at different points in time. So a second decision was to move to a market-determined interest rate system by adopting the practice of auctioning government securities. Finally, when the FRBM Act was enacted in 2003, the RBI was no longer allowed to subscribe to primary issuances of the Government of India. It had the right to engage in open market operations (OMO) in the secondary market for liquidity adjustment or other purposes and accept government securities when they devolved to the Bank, which underwrote those issues as the sovereign debt manager. This did, indeed, enhance its relative independence, with the repo rate "administered" by it, rather than the "market", being a major influence on the structure of interest rates (RBI, 2013: Chapter 3).

### *2.2.1 Liberalizing the exchange rate regime*

Alongside fiscal reform, on the monetary policy side, reform entailed adjusting central bank intervention to the imperatives created by a liberalized and globalized economy in which forces and mechanisms affecting financial variables such as interest and exchange rates became more complex. An important change in the RBI's operations resulted from the shift to a liberalized exchange rate management system in March 1992. Following independence and up until September 1975, the rupee was pegged to the pound sterling, with changes in the exchange rate only as a result of official devaluations as in 1966 and 1971.

On 24 September 1975 the rupee was delinked from the pound sterling and shifted to a managed floating exchange rate regime, in which it was linked to a basket of currencies of India's major trade partners. This continued until July 1991 when, after a two-step devaluation, the rupee was shifted in March 1992 to the Liberalized Exchange Rate Management System (LERMS). Initially, LERMS was a dual exchange rate regime: (i) an official rate applied to selected imports – such as oil – and to 40 per cent of export and invisible receipts and International Monetary Fund (IMF) transactions; and (ii) a market rate applying to other external transactions determined by the supply of and demand for foreign exchange. Finally, in March 1993, the exchange rate for all transactions was freed to be determined in the market. In parallel moves, authorized dealers were allowed to offer forward cover for foreign exchange transactions and measures were adopted to allow for hedging against exchange rate risk.

Under this regime, the RBI could 'manage' the exchange rate only through "open market operations", purchasing dollars to prevent an appreciation of the rupee and selling foreign exchange to forestall depreciation. Since such operations affected the Bank's foreign exchange asset positions, and therefore its liabilities (under the double entry accounting system[1]), the efforts at exchange rate management had implications for the management of the money supply.

This link between exchange rate management and management of the money supply gained significance as the liberalization of capital inflows into the country resulted in periods characterized by a surge in inflows and those in which net inflows were negative. Since such surges affected the exchange rate, the RBI had to intervene to accumulate or reduce foreign exchange assets, with attendant unintended consequences for the money supply.

Since the early 1990s, the gradual but continual liberalization of financial prices (including the exchange rate), the entry of new domestic and foreign players into financial markets, and the greater freedom to issue new instruments, including hybrids, and hedging instruments, were altering the nature of financial intermediation and the channels for policy transmission. Moreover, the greater integration of the economy through, not just trade but enhanced cross-border financial flows, implied that monetary policy had to take account of a host of exogenous influences (Mohan, 2008), captured in primitive form by the notion of the "impossible trinity"[2].

### 2.2.2 *"Delinking" the budget deficit from monetization*

It was in April 1998 that the RBI decided to shift away from treating broad money (M3)[3] as the nominal anchor for its monetary policy, based on the premise that there existed a stable relationship between money, output and prices. The revised approach that was gradually put in place was one that paid attention to multiple indicators (such as inflation and exchange rates; interest rates or rates of return in different financial markets, along with information on currency; credit; trade; capital flows; the Government's fiscal position; as well as output trends) when formulating monetary policy.

The enactment of the FRBM Act in 2003 led to the Reserve Bank withdrawing from participation in the primary issues of Central Government securities with effect from April 2006. This reduced the Bank's ability to use the sale of assets in the form of government securities to sterilize the effects of foreign exchange reserve accumulation, resulting from its operations in the foreign exchange market.

These developments, in turn, triggered a shift in emphasis from direct instruments of monetary policy in the form of reserve requirements and liquidity pre-emption (through the

[1] A double entry system is a system of accounting where every transaction is recorded in two accounts – as a credit and debit – so that aggregate credits equal aggregate debits.

[2] Economic theory posits the "impossible trinity" as the impossibility of simultaneously (i) maintaining a stable foreign exchange rate; (ii) allowing the free movement of capital across national borders; and (iii) conducting an independent monetary policy at the same time. One of these three elements is usually sacrificed to maintain the other two in the long-run.

[3] Broad money – or M3 – consists of notes and coins, as well as bank and other deposits.

statutory liquidity ratio (SLR), for example)[4] to indirect instruments such as the liquidity adjustment facility, open market operations in government securities, auctions to determine the interest rate structure for loans of various tenors and (in 2004) a Market Stabilization Scheme, under which the RBI is permitted to issue government securities to conduct sterilization operations, the timing, volume, tenure and terms of which are at its discretion. The ceiling on the maximum amount of such securities that can be outstanding at any given point in time is decided periodically through consultations between the RBI and the Government. Since the securities created are treated as government deposits with the Reserve Bank, it appears as a liability on the Bank's balance sheet and reduces the volume of net lending to the Central Government, which has, in fact, turned negative. By increasing such liabilities, subject to the ceiling, the RBI can balance increases in its foreign exchange assets to differing degrees, control the level of its assets and, therefore, its liabilities. The money absorbed through the sale of these securities is not available to the Government to finance its expenditures but is held by the Reserve Bank in a separate account that can be used only for redemption or buy-back of these securities as part of the Bank's operations. As far as the Central Government is concerned, while these securities are a capital liability, its "deposits" with the Reserve Bank are an asset, meaning that the issue of these securities does not make any net difference to its capital account and does not contribute to the fiscal deficit. However, the interest payable on these securities has to be met by the Central Government and appears in the budget as part of the aggregate interest burden.

Meanwhile, legislative amendments increased the flexibility with which the Reserve Bank could use instruments such as the cash reserve ratio (CRR) and SLR. There was no statutory floor to the CRR, and the SLR could be reduced below its statutory minimum of 25 per cent of net demand and time liabilities (NDTL). These changes substantially strengthened the Bank's liquidity management powers.

According to former RBI Governor Y. V. Reddy: "Some of the important factors that shaped the changes in monetary policy framework and operating procedures in India during the 1990s were the delinking of budget deficit from its automatic monetization by the Reserve Bank, deregulation of interest rates, and development of the financial markets with reduced segmentation through better linkages and development of appropriate trading, payments and settlement systems along with technological infrastructure." (Reddy, 2007).

### 2.2.3 Fiscal policy and inflation targeting

In terms of the objectives of monetary policy, once GDP growth accelerated from 2004-05 onwards, price stability began receiving greater attention, though the stated objective of monetary policy was to ensure *both* price stability and an adequate flow of credit in the interests of growth. However, it was in the report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework, chaired by Deputy Governor Urijit Patel, in January 2014 that emphasis was placed on "inflation targeting". In fact the Committee recommends a strict version of the inflation targeting framework. To start with, it recommends that a nominal inflation rate of 4 per cent (surrounded by a 2 per cent band) should be the "target" of monetary policy, which must subordinate all other objectives, including growth, to that goal. It is only, "subject to the establishment and achievement of the nominal anchor," that monetary policy "should be consistent with a sustainable growth trajectory and financial stability". A second recommendation of the Committee is that the

[4] The statutory liquidity ratio (SLR) specifies reserve requirements for commercial banks in the form of specified (normally government) securities (besides gold). The SLR requirement has been continuously reduced from a peak level of 38.5 per cent of net demand and time liabilities (NDTL) of the banking system to 22 per cent in 2014.

combined Consumer Price Index (CPI) that has been released since early 2011 – as opposed to the Wholesale Price Index – should be the basis for calculating the rate of inflation.

Third, while recognizing that the food and fuel groups are overwhelmingly responsible for consumer price inflation, and that inflation in these commodity groups is driven from the cost/supply side and often imported, the Committee still believes that "headline inflation" (as measured by the CPI in full) as opposed to "core inflation" (which excludes commodities like food and fuel from the calculation) should be the anchor. This, according to the Committee, is because holding down inflation requires dampening "inflation expectations" that contribute to the inflationary trend. In its view: "high inflation in food and energy items is generally reflected in elevated inflation expectations. With a lag, this gets manifested in the inflation of other items". Moreover: "Shocks to food inflation and fuel inflation also have a much larger and more persistent impact on inflation expectations than shocks to non-food non-fuel inflation. As such, any attempt to anchor inflation expectations cannot ignore shocks to food and fuel."

Having decided that inflation targeting should be the main focus of monetary policy, the Patel Committee goes on to prescribe a simple rule of thumb: when the inflation rate is above the nominal anchor, the real policy rate, which is to be the overnight repo rate at which banks can access liquidity adjusted for inflation, should be positive. The degree to which it is in positive territory is determined by the Monetary Policy Committee, taking account of the output gap or the level of actual output growth relative to trend or potential, which is a form of the Taylor rule[5].

This emphasis on a single policy instrument is strengthened by the requirement set by the Committee that, to ensure transmission of policy impulses in the form of interest rate adjustments, no discretionary measures to enhance liquidity should be adopted. Provision of liquidity by the RBI at the overnight repo rate is to be "restricted to a specified ratio of bank-wise net demand and time liabilities (NDTL), that is consistent with the objective of price stability." In addition, any measures of credit allocation to specific sectors that influence the level of liquidity in the system must be abjured. And, since the interest rate is to emerge as the crucial policy variable, sector-specific interest rate subventions are to be phased out.

Across the world, contemporary discussions in policy-making circles and elsewhere on fiscal and monetary policy are overwhelmingly influenced by those advocating "fiscal consolidation" on the one hand, and "inflation targeting" by an independent central bank on the other. As a result, concern for the effects that macroeconomic policies can have on growth and the quantum and quality of employment has taken a back seat. This is indeed surprising, because one of the consequences of the Keynesian revolution was that it made the unemployment of resources, especially labour, the fundamental imbalance that a proactive macroeconomic policy must address. In India, too, ostensibly in an effort to end fiscal dominance, such a shift is occurring, even though, compared to many other emerging markets, India has not been a victim of hyperinflation, which has often been held up as strong justification for such policies, which privilege the inflation problem over growth. This marks a departure from the perspective held over a long, post-independence phase in which fiscal policy was seen as the principal instrument in the hands of government to ensure growth in output and employment.

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[5] A Taylor rule is monetary policy rule – stated by Taylor (1993) – whereby the nominal interest rate responds to divergences of actual inflation rates from the target inflation rate and of actual GDP from potential GDP.

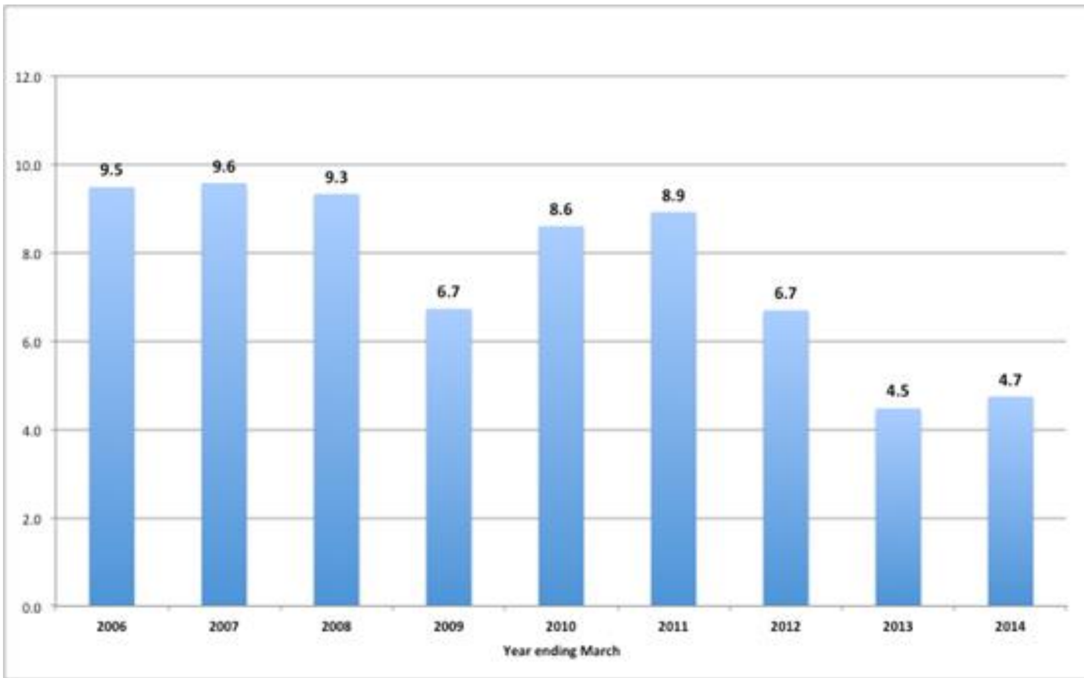
### 2.2.4 Impact of the global financial crisis

The Urijit Patel Committee report has yet to be accepted and implemented in full. But the situation is one where macroeconomic policy in India is moving in a conservative direction. This is surprising for two reasons. First, while, globally, countries had moved in that direction well before India, the global financial crisis questioned the unthinking adherence to these principles. Not only was the focus on goods price inflation, seen as responsible for the easy and cheap money policy that contributed to the crisis, as opposed to the asset price inflation that was rampant prior to 2008, but it was clear that what was considered a ‘stable’ macroeconomic policy stance was pro-cyclical and inimical to stability in the real economy. The experience and outcome of the fiscal and monetary stimulus in the United States after the crisis and the austerity imposed on some peripheral European nations only strengthened this view, calling for a return to a more balanced and nuanced macroeconomic policy stance that gave importance also to growth and employment objectives, as well as inflation.

Secondly, in India, too, the Government’s response to the crisis in the form of a stimulus necessitated an increase in the fiscal deficit-to-GDP ratio. Prior to the financial crisis, in financial year 2007-08, the central revenue deficit stood at 1.06 per cent of GDP and the gross fiscal deficit (GFD) at 3.3 per cent. The state governments, by 2006-07, had even recorded a revenue surplus of 0.58 per cent of GDP and a GFD of 1.81 per cent of GDP (De, 2012). With the onset of the crisis and its impact on India through diminished exports, capital flight and currency volatility (that would have damaged the balance sheets of firms with foreign currency debt exposure), the Government, in a series of announcements between December 2008 and February 2009, adopted a stimulus package which included a general central excise duty reduction of 4 per cent, an additional 2 per cent reduction in excise duties and service tax for export industries, boosting planned expenditure to the tune of INR 200 billion and additional borrowing limits of around INR 300 billion for planned expenditure by state governments, besides sundry other measures. The value of this mixed stimulus package was estimated at around 1.8 per cent of GDP (Kumar and Soumya, 2010).

The effect was salutary. GDP growth that had fallen from 9.3 per cent in 2007-08 to 6.7 per in 2008-09, rebounded to 8.6 per cent in 2009-10 and 8.9 per cent in 2010-11 (see Figure 3 below). However, the lessons that could be derived were ignored. Rather, attention was focused on the fiscal deficit and the inflation that accompanied the growth revival. The fiscal deficit-to-GDP ratio rose from 2.5 per cent in 2007-08 to 6 and 6.5 per cent respectively in 2008-09 and 2009-10. The budget for 2010-11 started the process of reversing this post-crisis trend with the fiscal deficit-to-GDP ratio projected at 5.5 per cent. It had fallen to 4.8 per cent when the estimates came in. This was only marginally due to a contraction in expenditure and improved tax collection, and largely explained by receipts from the sale of 3G and broadband spectrum (which are treated as non-debt capital receipts and excluded from the fiscal deficit computation) that proved a bonanza for the Government. Since the Government cannot ensure adequate assets sales in every year (and rely on them in the long run), the sharp deficit reduction in 2010-11 could not be sustained, with the figure rising to 5.7 per cent in 2011-12. Since then some privatization has been accompanied with reduced expenditure to bring the deficit down to 5.5 per cent in 2012-13 and 4.5 per cent in 2013-14. It is telling that, in those years, the GDP growth rate fell dramatically to 4.5 per cent and 4.7 per cent respectively, though the fiscal deficit reduction was not the only cause of this decline.

**Figure 3. Year-on-year growth of GDP at factor costs* (%) (2006-2014)**




Source: CSO (2014b).
*Note: GDP growth figures based on National Accounts Statistics with 2004-05 prices as base

## 2.3 Long-term fiscal trends

### *2.3.1 The pre-1991 fiscal policy stance*

Underlying these movements in expenditure and the deficit was a long-term weakness in the Indian *fisc*. It is well-recognised that the early 1990s were marked by a structural shift in the macroeconomic policy stance implicit in the rhetoric and, subsequently, actions of the Indian Government (through its Ministry of Finance) and the RBI (Chandrasekhar and Ghosh, 2004). Up to then, there had been three features that defined the macroeconomic stance of the Indian Government, two of which were in conflict.

One was the adoption of a proactive macroeconomic policy, influenced in the first instance by the belief that private investment would not occur in a number of infrastructure areas with strong and positive economy-wide externalities, and by the conviction that crucial industrial activities must be established in the public sector. Public spending, therefore, was expected to be far more than would have been the case if the Government had restricted itself to areas like defence, maintenance of the rule of law, and the provision of basic social services in areas like sanitation, health and education. In the absence of other measures (such as land reform) that could have expanded the domestic market for manufactures to support the industrialization effort, this public expenditure thrust became an important stimulus for industrial growth as well.

A second feature was the failure of the State to match its commitment to spend with resource mobilization through direct taxation, resulting in a growing dependence on debt and indirect taxation to finance its expenditures. With the availability of agricultural wage goods constrained from the supply side, this dependence on debt-financed spending to drive non-agricultural growth amounted to dependence on inflationary finance.

The third feature was that, while in the 1950s and 1960s resort to deficit financing was largely to finance capital expenditures, from the 1980s onwards, a rising revenue deficit suggested that such financing was substantially used to sustain current state expenditures. This meant that a given fiscal deficit (relative to GDP) contributed less to output and employment growth over time.

Finally, India's central bank, the RBI, was for long expected to accommodate the Government's financial requirements, by accepting and holding on demand ad hoc Treasury Bills that paid lower interest than bonds issued in the open market. Once the emphasis was on using the fiscal lever to accelerate development, the role of monetary policy became secondary. Monetary policy was adapted to serve fiscal requirements. By providing credit to the Government at interest rates below those prevailing in the market, the monetary authority was facilitating the pursuit of a proactive fiscal policy by reducing the Government's interest cost burden.

### 2.3.2 Implications for employment

The enhanced spending witnessed under this regime had three implications for employment. First, it resulted in increases in formal employment in the public sector. Second, the demand generated by government procurement and the salaries paid to its employees, and their multiplier effects, provided a market for the private sector. The resulting investment and growth in the private sector helped accelerate employment growth as well. Third, with the public sector offering 'decent' remuneration and conditions of work, it set the standard which workers in the private sector could refer to, if and when, negotiating better terms from their employers.

It was to be expected that this macroeconomic policy framework, anchored in debt-financed public expenditure, would prove unsustainable, given the significant supply-side constraints, especially in the agricultural sector. However, the problem arose, not because of the Government's decision to adopt a proactive fiscal policy stance to accelerate development, but from its inability to mobilize (in non-inflationary fashion) the resources needed to finance that strategy, besides adequately addressing the supply-side constraint in agriculture. The asymmetry in the use of the fiscal instruments of taxation, on the one hand, and spending, on the other, was the fundamental fiscal problem.

The unsustainability of the strategy was brought home by the inflationary crisis that followed the two bad harvests of the mid-1960s. High and persistent inflation forced the Government to cut back on its expenditures, leading to a deceleration in growth that lasted for more than a decade. This came to be identified as a period of 'secular stagnation' in India's post-independence history.

### 2.3.3 Foreign finance to the rescue

The first escape route from this development trap faced by a government caught between the need to spend and the unwillingness or inability to mobilize resources came in the 1980s. It came about because the Indian Government decided to follow the example of many other developing countries, and exploit access to international liquidity offered by the huge expansion of the international financial system in the 1970s and after. The first signal was the decision to negotiate a 5 billion Special Drawing Rights (SDR) line of credit from the IMF in the early 1980s to meet the challenge set by the two oil shocks of the 1970s. Access to that line of credit over a three-year period, the Government argued, would allow India to liberalize trade and foreign investment policies, restructure its economy, and emerge as a successful exporter able to earn the foreign exchange to more than finance its increased oil import bill.

The second was to liberalize access of resident firms to the international market for debt. The net result of this was that the external debt-to-GDP ratio doubled over the 1980s, when trade liberalization was widening the trade and current account deficits. That, however, was not the problem that it had been in the late 1960s and 1970s, because, in the changed international financial scenario, the deficit could be funded with capital inflows from abroad, especially in the form of debt. At first it appeared that India could sustain this trajectory for quite some time, because its external debt-to-GDP ratio was far lower than in many other developing countries, especially those in Latin America that were, by then, facing a debt crisis. However, having burnt their fingers in Mexico and elsewhere in the early 1980s, international banks had turned more wary. Faced with a rising current account deficit-to-GDP ratio and a rising external debt-to-GDP ratio, they cut back on their lending to India, resulting in the balance of payments crisis of 1991.

Nevertheless, access to international finance changed the macroeconomic environment and made the 1980s an unusual decade. Three developments during the decade allowed the economy to escape from the growth impasse of the earlier period. First, there was a huge increase in government spending resulting in a large fiscal stimulus to growth. Second, there was substantial liberalization of imports, especially of capital goods and components for manufacturing. Third, associated with both of these, there was a shift to reliance on external commercial borrowing to finance the resulting increases in the fiscal and current account deficits.

The gross fiscal deficit of the Central and state governments together averaged 9.5 per cent of GDP at current market prices in the second half of the 1980s and touched 10.1 per cent in 1990-91. This was not due to any increase in the share of public investment, but largely the result of a decline in the share of public savings, reflected in the burgeoning revenue deficit (which rose from an average of 2.8 per cent of GDP during 1985-86 to 1989-90 to 4.5 per cent in 1990-91).[6] Current expenditures of the State grew at a rate which outstripped by far the growth in tax and non-tax revenues, despite hikes in indirect taxation and in administered prices.

What mattered, however, was that, unlike in the mid-1960s, this heavy reliance on debt-financed current expenditures did not result in high inflation. This was because of the increased ability to access foreign exchange and import the goods needed to dampen domestic inflation by enhancing domestic availability of supply-constrained tradables. Such imports partly contributed to the widening trade and current account deficits.

Thus, the revival of growth in India during the 1980s is easy to explain. Exploiting the access to foreign exchange afforded by the rise to dominance of finance internationally, the Government chose to pump-prime the system. Rising government expenditure, however, was not accompanied by an increase in resource mobilization through raising taxes. The fiscal stimulus was financed through rising deficits, including a rising deficit on the revenue account of the Government budget. The demand stimulus resulting from such expenditure was serviced by domestic industry with the help of imported capital goods, intermediates and raw materials, imports of which were liberalized. This essentially meant that the import intensity of domestic production rose. But such growth was not constrained by inadequate access to foreign exchange, since it was accompanied by an increase in foreign borrowing from the IMF, the international commercial banking system and non-resident Indians (NRIs). Fortunately for India, this was the time when remittances from Indian workers – especially in the Gulf – to support consumer spending by families left behind, provided the country with a fortuitous inflow of foreign exchange. Despite this, the country's foreign debt-to-GDP ratio doubled during the 1980s. It was when international

[6] Figures computed from data collected from the Ministry of Finance (various issues) and CSO (2014b).

creditors chose to shut off such credit at the end of the 1980s that India ran into the balance of payments crisis of 1990-91, which provided the grounds for advocates of reform to push through an IMF-style stabilization and adjustment strategy.

If the large fiscal deficits of the 1980s had not been accompanied by large current account deficits on the balance of payments, the inflationary overhang would have grown faster and there would have been much higher inflation than actually occurred. On the other hand, if the current account deficit had been as large as it was, owing to import liberalization, but the fiscal deficits had actually been smaller, then imported goods would have undercut domestic goods and penetrated the domestic market to a greater extent, since the home market would have been narrower with a smaller fiscal deficit, and the rate of industrial growth would have been lower.

Nevertheless, while the industrial boom of this period seemed to paper over the basic contradictions of the regime, it left the economy sitting on a powder keg. The enormous external debt, a growing portion in the form of short-term borrowing, made the economy acutely vulnerable to currency speculations and crises of confidence among international investors. This type of vulnerability was an entirely new phenomenon for the Indian economy. The liquidity build up in the domestic economy that inevitably followed made it acutely vulnerable to sudden inflationary upsurges. This was dramatically illustrated in 1990-91, which experienced an inflationary episode on account, largely of speculative stock-holding, and a balance of payments crisis largely caused by non-resident Indians taking funds out.

It is the combination of the three features mentioned above which explains the State's ability to pull the economy out of the impasse it faced during the late 1960s and 1970s. Increased government spending stimulated demand and growth directly through the ensuing procurement as well as indirectly through the multiplier effects of the new incomes it generated. The impact that the resulting growth had on employment, though not satisfactory in terms of reducing underemployment and improving the terms and conditions of work, was indeed positive.

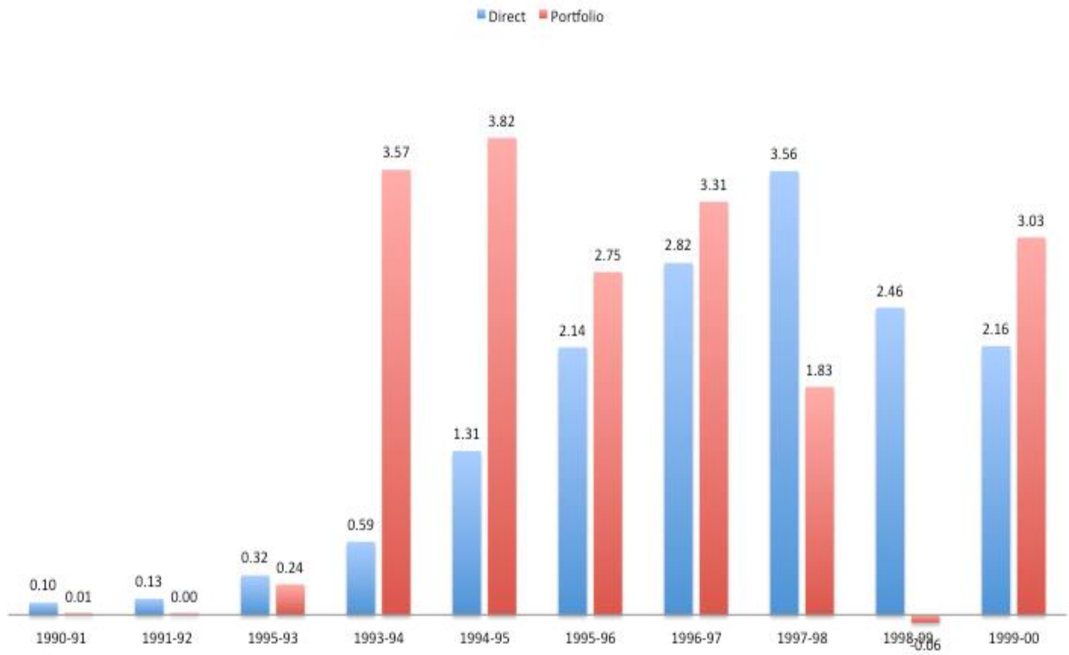
There were many lessons to be learnt from the 1980s experience. First, despite liberalization, however limited in terms of the size of the Indian economy and its specific characteristics, growth depended on the fiscal stimulus that government expenditure provided, rather than on an expansion of exports. Second, if such government expenditure was not accompanied by tax and other measures aimed at mobilizing additional resources, but was financed through borrowing, the excess demand in the system was bound to spill over in the form of either inflation or a current account deficit. Third, if inflation was kept under control through imports, greater dependence on external capital to finance the resultant deficit on the current account would be inevitable.

## 2.4 Fiscal policy challenges

### *2.4.1 Increased dependence on foreign capital*

Interestingly, the direction that the Government took after the 1991 crisis was to further increase dependence on foreign capital, by liberalizing rules governing purely financial flows and allowing foreign institutional investors to register and trade for capital gains in India's equity markets as well as invest in debt markets. The impact of this is quite evident. Foreign investment flows, that were miniscule in the early 1990s, rose sharply from 1993-94, with the largest increase in portfolio or financial flows (Figure 4 below). However, as the experience in 1998-99 (and more recently in 2008-09) showed, these flows can be quite volatile.

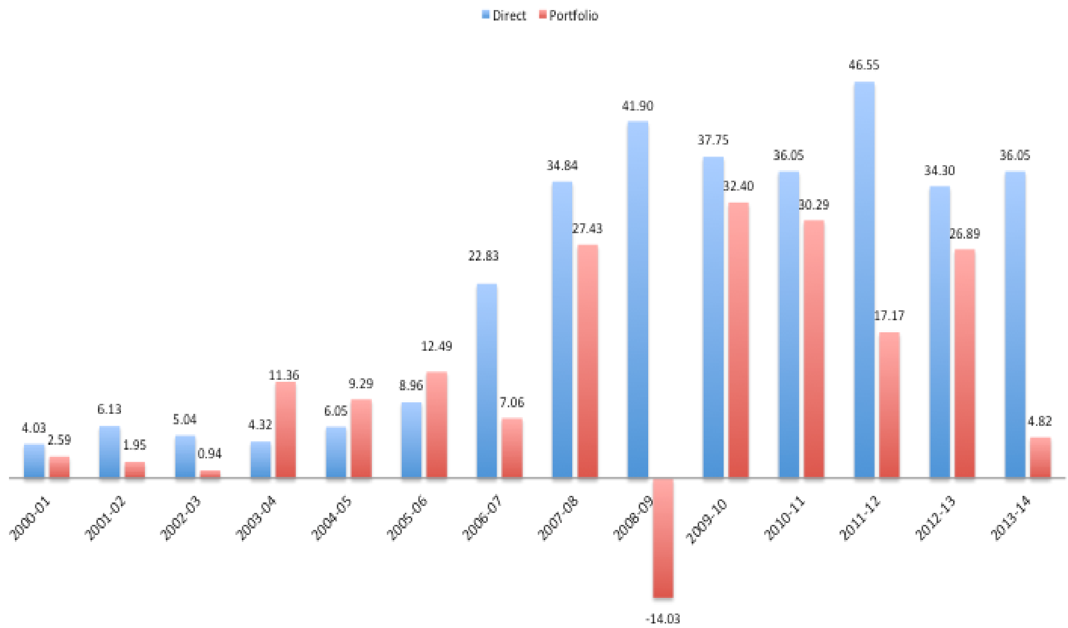
**Figure 4. Foreign investment flows (billions of dollars) (1991-2000)**




Source: RBI (various issues – b).

One consequence of the enhanced flows was that the cumulative presence of foreign institutional investors (FII) in Indian markets amounted to around US$ 15 billion at the beginning of the 2000s. It was after 2003-04, when globally there was a surge in cross-border flows of capital, that India emerged as a favoured destination (Figure 5), taking net cumulative flows to US$ 36 billion by 2004-05 and US$ 190 billion in June 2014. One result of the cumulative presence of this otherwise volatile capital is that economic policy becomes sensitive to the demands of investors, who might choose to exit if they fear the consequences of government policies.

**Figure 5. Foreign investment flows (billions of dollars) (2000-2014)**




Source: RBI (various issues – b).

One such demand is for a substantial reduction in the fiscal deficit. Financial investors are against deficit-financed spending by the state for a number of reasons. First, deficit financing is seen to increase the liquidity overhang in the system, and, therefore, as being potentially inflationary. Inflation is anathema to finance, since it erodes the real value of financial assets. Second, since government spending is "autonomous" in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive. Their activities can make the interest rate differentials that determine financial profits more unpredictable. Third, if deficit spending leads to a substantial build-up of the state's debt and interest burden, it may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending.

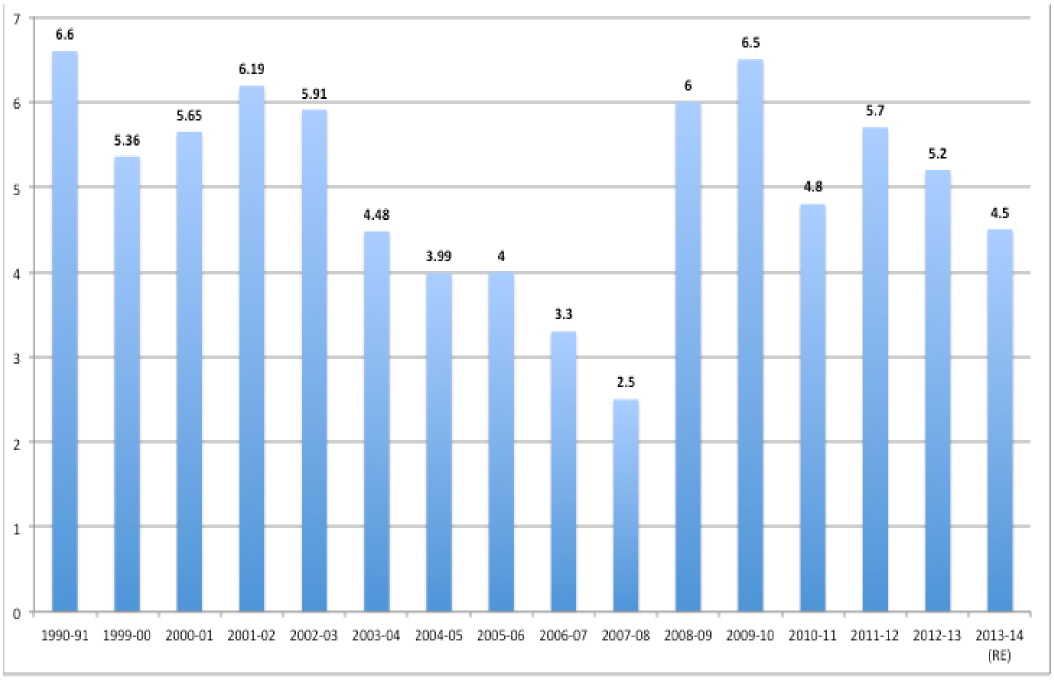
Thus, while it is true that there was also a section in the policy-making establishment that was in favour of fiscal consolidation through expenditure reduction, the growing presence of international finance in India was a strong influence on fiscal policy. In time, curtailment of the fiscal deficit became the fundamental task of fiscal policy.

### *2.4.2 Failure to raise tax revenues*

However, as noted earlier, the Government's success in the pursuit of this policy has been limited. Market-friendly "reform" that wants to incentivize the private sector with a combination of fiscal concessions and reduced taxes makes fiscal consolidation dependent on expenditure reduction. Successive governments since 1990 have adopted a contradictory long-term fiscal policy in the name of "reform". An undeclared feature of that policy is tax lenience and forbearance, sometimes pursued in the name of rationalizing the tax system and at other times adopted as part of the scheme of incentivizing private investment. The net result is that, although it is well recognised that India is a low tax nation when assessed in terms of its tax-to-GDP ratio, fiscal "reform" has done little to raise that ratio. On the other hand, given the "stickiness" of many items of expenditure such as the Government's wage bill and interest payments on past debt, it is known that the reduction focuses on social and capital expenditures. Such reductions are more difficult to achieve, however, so targets had to be periodically revised and it is only recently that the Government has been nearing its goals.

The trap in which the Government finds itself is that, despite holding back on expenditure, its success in reining in the fiscal deficit has only been partial. The FRBM Act was adopted in 2003 and amended in 2012. But targets have been deferred time and again, and only now is the Government on track to meet its current goal of a deficit of 3 per cent of GDP by financial year 2017 (Figure 6). The only time when the Government appeared to be on track in pursuit of this goal was the high growth years between 2003-04 and 2007-08. Even then, the remarkably low 2.5 per cent figure for 2007-08 was largely because of windfall receipts of INR 125 billion from sale of telecommunication spectrum to new entrants.

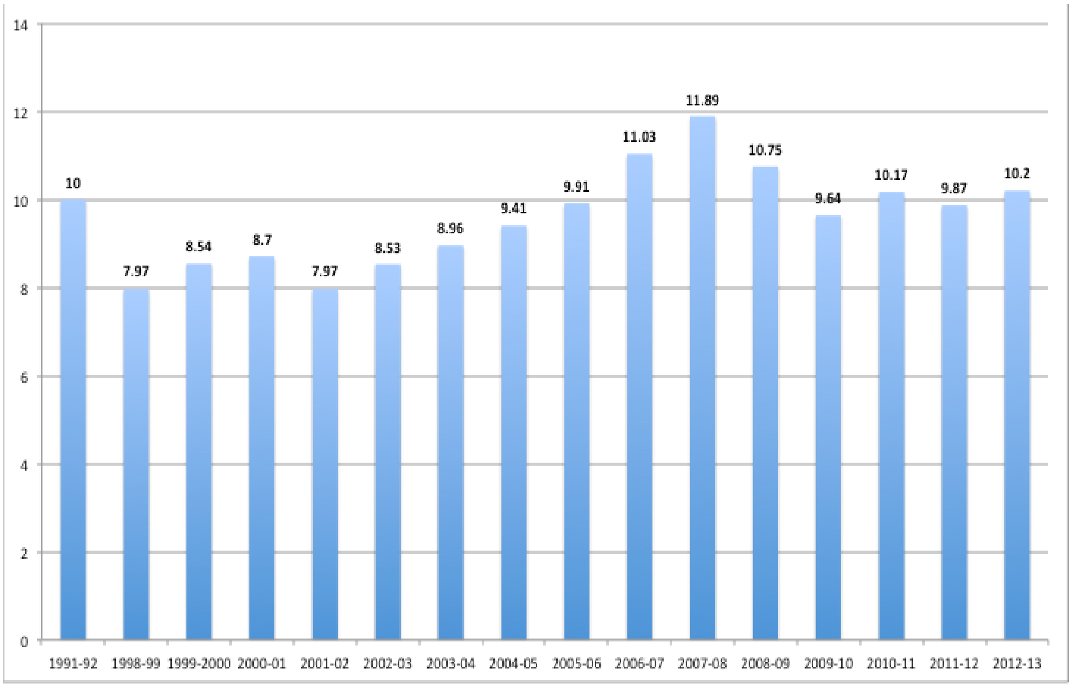
**Figure 6. Fiscal deficit-to-GDP ratio (%) (1990-2014)**




Source: Computed from Ministry of Finance (various issues) and CSO (2014b).

Three features are revealed by trends in the central tax-to-GDP ratio since 1990 (Figure 7). The first is that the immediate effect of reform was not to improve but to depress the tax-to-GDP ratio, which fell from 10 per cent in 1991-92 to 7.97 per cent in 1998-99. Second is the claim that fiscal reform had addressed the problem of a low tax-to-GDP ratio based on figures relating to 2006-08 cannot be sustained. In fact the improvement in tax performance during 2003-04 and 2007-08 seems to be the result of the level and nature of growth during the mid-2000s, when high growth was accompanied by sharp increases in corporate profits and an exceptional expansion of services. When growth was affected by the global crisis and the Government had to provide some tax concessions as part of its stimulus package, the ratio fell during 2008-10. Third, on average after 2007-08, the tax-to-GDP ratio found a lower level despite variations in annual growth. In sum, the effect of fiscal reform on the revenue side seems to be a failure to correct the long-term inadequacy of the tax effort at the central level, and an aggravation of the procyclicality of revenue mobilization. Higher growth seems to yield higher revenues, while a slowdown depresses revenues.

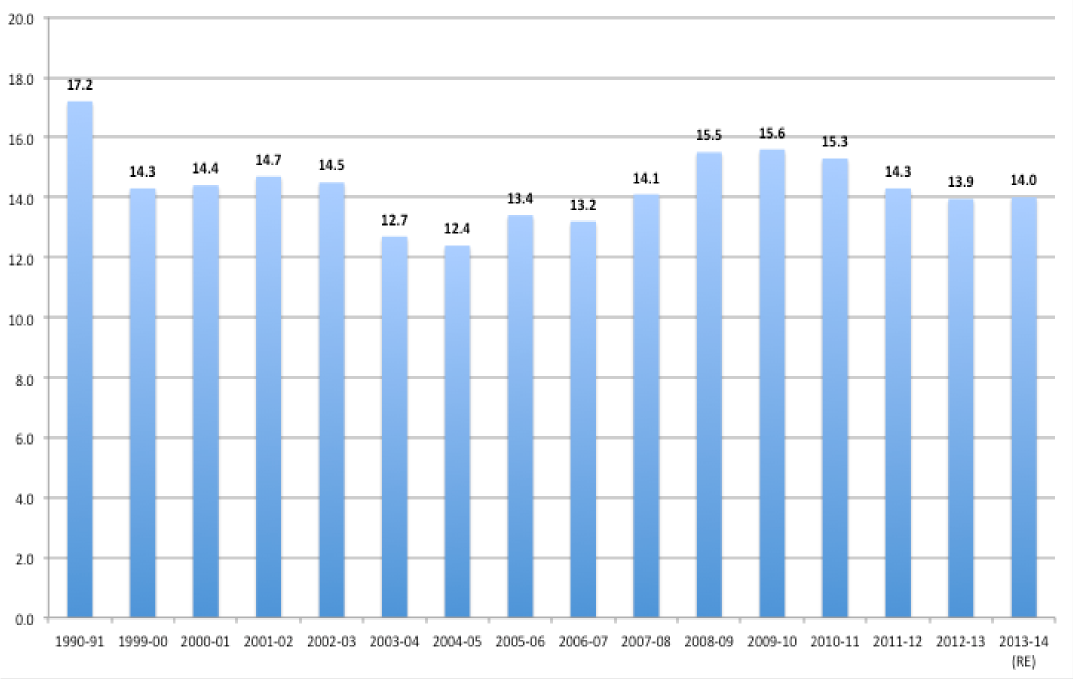
**Figure 7. Central tax-to-GDP ratio (%) (1991-2013)**




Source: Computed from Ministry of Finance (various issues) and CSO (2014b).

When this failure is combined with the commitment to what is euphemistically called fiscal consolidation in the form of a reduced fiscal deficit-to-GDP ratio, the impact on expenditure can only be adverse. As Figure 8 shows, the ratio of total Central Government expenditure to GDP fell quite sharply in the first decade-and-a-half after the “reform” began. It remained at indifferent levels even during the high growth years up to 2007-08, and then rose in the aftermath of the global crisis as part of the consciously adopted stimulus package. Underlying these trends is the fact (discussed below) that the 2000s boom in the Indian economy was not driven by public expenditure, but by private consumption and investment expenditures that were in substantial measure debt-financed, facilitated by a credit boom. That boom has now ended.

**Figure 8. Central expenditure-to-GDP ratio (per cent)**




Source: Computed from Ministry of Finance (various issues) and CSO (2014b).

Fiscal reform in India has largely failed because it has done little to increase revenue generation through taxation. The trap in which the Government finds itself is that, despite holding back on expenditure, its success in reining in the fiscal deficit has only been partial. The problem is that this is not a regime suited to growth in output and employment.

In fact, faced with a rising backlog of unemployed, governments at the Centre and in the states have, over time, announced and implemented a range of employment generation schemes. The most recent and ambitious of them is the Mahatma Gandhi National Rural Employment Guarantee Scheme, which promises to provide on demand 100 days of employment for one member of each household. The difficulty with these schemes (providing employment in areas such as road-laying or flood control) is that even when they generate productive assets they do not yield significant positive revenues. So they need to be financed by the budget. Hence, when the Government faces a fiscal crunch, the axe falls on them. Fiscal consolidation not only reduces the pace of employment generation in the system, but it also erodes the little protection that is offered to the unemployed poor.

# 3. Monetary policy

## 3.1 Overview

Just as governments pursue fiscal consolidation to appease foreign financial interests that abhor deficits, a restrictive monetary policy with high interest rates also seems to be influenced by foreign finance. As noted earlier, associated with the turn in the fiscal policy regime in India starting in the 1990s was a shift in the Government's monetary policy stance. The emphasis has been on delinking monetary developments from fiscal policy.

The reduction, indeed the elimination, of *ad hoc* issues or the "right" of the Government to access on demand credit from the RBI, was seen as essential to giving the Central Bank a degree of autonomy and, thus, monetary policy a greater role in the economy. This in turn stemmed from the premise that monetary policy should have a greater role than fiscal manoeuvrability in macroeconomic management. The problem, however, is that the interest rate on borrowing from the open market was much higher than the interest rate on borrowing from the RBI. The reduction of such borrowing from the Reserve Bank to zero resulted in a sharp rise in the average interest rate on government borrowing, which weakened the fiscal lever even further.

The principal argument justifying the elimination of the monetized deficit or borrowing from the Reserve Bank was that such borrowing is inflationary. The notion that the part of the fiscal deficit financed by borrowing from the Reserve Bank is more inflationary than a fiscal deficit financed with open market borrowing, stems from the idea that the latter amounts to drawing on the savings of the private sector, while the former merely creates more money. In a context in which new government securities are ineligible for refinancing from the RBI, and the banking system is stretched to the limit of its credit-creating capacity, this would be valid. However, if banks are flush with liquidity (as has been true of the Indian economy since at least 1999), government borrowing from the open market adds to the credit created by the system rather than displacing or crowding out the private sector from the market for credit (Patnaik, 1995).

It is relevant to note here that the decision to eliminate the practice of monetizing the deficit hardly affected the fiscal situation. Fiscal deficits remained high, though they were financed by high-interest, open-market borrowing. The only result was that the interest burden on the Government shot up, reducing its room for manoeuvre with regard to capital and non-interest current expenditures. As a result central government revenue expenditures rose relative to GDP, even when non-interest expenditures (including those on subsidies) fell, and the fiscal deficit continued to rise.[7]

## 3.2 The interest rate under the independent central bank

Interestingly, the policy adopted by the RBI in the period since it gained relative independence, starting in 2006, is an emphasis on the benchmark interest rate (or the repo rate at which the Reserve Bank accommodates banking sector demands for liquidity), rather than the level of liquidity in the system, as its policy variable when addressing inflation. Overall, the liquidity situation has been easy, partly because a long-term consequence of monetary reform has been an increase in the credit creating capacity of banks, through the reduction of both the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR)[8]. The other factor increasing the liquidity overhang in the system was the surge in foreign capital inflows into India after 2003-04, as noted above. This infusion of liquidity occurs directly through the infusion of funds into markets or indirectly as the result of an increase in the Reserve Bank's foreign exchange assets and therefore of its liabilities. Associated with this increase in liquidity, especially since 2003-04, has been an increase in scheduled commercial banks credit in the system.

In fact, a defining feature of the high growth period between 2003-04 and 2007-08 has been the substitution of debt-financed private expenditure for tax and debt-financed public expenditure as the principal stimulus for growth. The ratio of bank credit outstanding to GDP, which had remained at around 22 per cent for a decade from 1989-90, rose thereafter to reach 44.4 per cent in 2005-06 and a remarkable 56 per cent by 2011-12.

[7] For an estimate of the impact of the ending of monetization on the government budget, see Chandrasekhar and Ghosh (2004): p. 81.
[8] Under the SLR arrangement, banks are required to keep a certain proportion of their net liabilities as deposits with the central bank or as investments in selected government securities.

This increase in outstanding bank credit was accompanied by significant increases in the share of credit allocated to two segments: retail loans and infrastructure. The share of personal loans increased from slightly more than 9 per cent of total outstanding commercial bank credit at the end of March 1996 to more than 22 per cent by end-March 2007. While much of this credit went to support investments in housing, it also helped to substantially increase purchases of automobiles and consumer durables as well as general expenditures financed with credit card debt.

The other area that benefited from the credit boom was infrastructure. Given the Government's push in this area, by the end of 2012 there were over 900 public-private partnership (PPP) projects at different stages of implementation in the infrastructure sector involving a total project cost of INR 5,430 billion. Clearly, the private sector was not capable of self-financing that kind of expansion. With a sluggish bond market, the Government decided to prod public sector banks into lending to this sector. Not surprisingly, bank lending to infrastructure rose from just 3.6 per cent of bank credit to industry and 1.6 per cent of total bank credit at end-March 2000, to as much as 35 per cent of bank credit to industry and 13.4 per cent of total bank credit by end-March 2013.

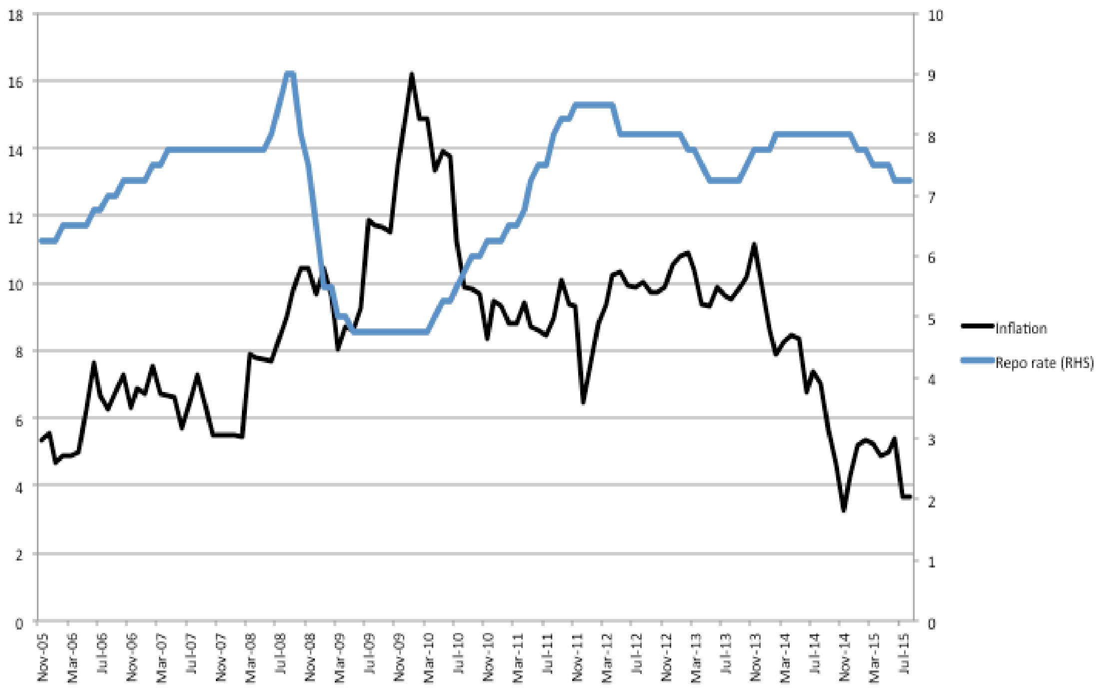
For quite some time, this credit-financed spending increased demand and stimulated growth. Along such a trajectory, an easy money policy is crucial to sustaining growth, so long as defaults are low and the banks remain solvent. However, more recently, defaults have been on the rise. Such defaults have long been reported in the housing and automobile sectors, but the number and proportion is rising. According to data from the Credit Information Bureau (India) Limited, the value of lawsuits filed against wilful defaulters of loans of over INR 2,500,000 by banks and institutions rose from INR 98 billion in September 2002 to INR 106.21 billion in September 2007 (or around the time the financial crisis broke) and INR 437.77 billion at the end of June 2015 (CIBIL, 2014). This, however, does not include restructured assets which are still stressed and undeclared non-performing assets held by wilful defaulters i.e. those who default despite having the ability to pay. In fact, corporate borrowers, especially in the infrastructure area, are finding it increasingly difficult to meet the interest and repayment commitments associated with their large debts. This had gone unnoticed because, desperate to protect their books, banks have been restructuring their loans. As a result, while the ratio of gross non-performing assets (NPAs) to total infrastructural loans rose from 0.61 per cent to 1.45 per cent between March 2009 and March 2013, the ratio of gross NPAs and restructured advances to infrastructural loans rose from 4.66 per cent to 17.43 per cent. That is rather ominous, given the fact that that many restructured 'standard' advances subsequently had to be characterized as non-performing (RBI, various issues – b).

With defaults on the rise, banks have turned cautious with regard to lending, and the RBI's decision to maintain high interest rates in response to inflation has also reduced credit offtake. In the event, the credit stimulus to growth has weakened and is proving ephemeral, which may explain the more recent slowdown in growth (see Figure 3 on p. 9). But this is no guarantee that defaults on past exposure would not rise. If they do, banks, too, can be vulnerable. A Credit Suisse India report tracking borrowing by 10 leading Indian business groups that are among the biggest corporate borrowers, found that these groups (Adani, Essar, GMR, GVK, Jaypee, JSW, Lanco, Reliance ADA, Vedanata and Videocon) have been on a borrowing spree (Gupta and Kumar, 2012). Their liabilities had increased six-fold over the six years ending March 2013 to touch INR 6.31 trillion and they accounted for close to 35 per cent of gross bank credit outstanding from scheduled commercial banks to large industry, and 28 and 11 per cent respectively of bank lending to industry and all sectors. Bank exposure here is large enough to trouble the banks if the firms concerned are in trouble. This too inevitably encourages a reduction in both credit and investment.

While an easy money policy sustained this trajectory for a time, the RBI faced a challenge in the form of inflation. In almost every month in the period from March 2009 to May 2014, the month-on-month annual rate of inflation was above 8 per cent (see Figure 2 on p. 2). While imported inflation aggravated by rupee depreciation in certain periods played a role, these were by no means the only or even dominant drivers, excepting in periods when oil prices recorded steep increases. While exchange rate pass-through has been significant in post-liberalization India, it has been incomplete (Khundrakpam, 2007; Pyne and Roy, 2010). In fact multiple domestic factors (administered price increases, demand and supply imbalances, and speculation) have combined to keep high inflation going. If there is an element common to them all, it is that many of them are the outcome of economic reform. India's vulnerability to the effects of changes in international prices has increased with trade liberalization. Increased concentration due to the dilution of anti-trust measures and reduced regulation tend to encourage a profit-driven escalation of the prices of certain manufactured goods, as exemplified by pharmaceuticals. Imbalances between demand and supply of primary products are accentuated by the Government's reluctance to release more food through the public distribution system at below poverty line prices. The effort to reduce subsidies has resulted in a continuous increase in the prices of commodities such as petroleum and fertiliser that are administered. The list is long and almost endless. The processes of liberalization and deregulation are creating a high inflation economy.

In response, the RBI has relied largely on the interest rate as the lever to influence and control inflation. Starting from a low of 4.75 per cent in July 2009, the benchmark repo rate was raised in a series of steps to reach 8.5 per cent in April 2012. Since then it has fluctuated between 7.25 per cent and 8 per cent. Prima facie, there does appear to be a relationship between the level of the repo and year-on-year inflation rates in the corresponding months. The low interest regime in the aftermath of the global crisis was accompanied by a spike in inflation and the high interest rate regime of the recent period does seem to be associated with lower inflation rates (Figure 9). However, a high interest rate regime has other adverse implications.

**Figure 9. Inflation and repo rate (Nov. 2005-July 2015)**




Source: RBI (various issues – a).

The repo rate, i.e. the interest rate at which the Reserve Bank accommodates the short term liquidity needs of the banking system, is an important influence on the structure of interest rates in India. High interest rates, it is argued, can adversely affect growth by discouraging industrial and agricultural investment as well as curbing the volume of debt-financed household investment and consumption. This explains why a reduction in interest rates is expected when growth is sluggish. But the real problem, the RBI argues, is that inflation is high.

Nevertheless, the consistent adherence to a high interest rate regime suggests that there could be factors other than inflation influencing the Reserve Bank's interest rate policy. One such influence may be the effect interest rates have on inflows of foreign portfolio investment. A high interest rate regime is one way of encouraging foreign investment inflows and preventing outflows. That relationship seems to be confirmed by the large net inflows of foreign portfolio capital into India during the period of high interest rates. Moreover, a rising share of institutional investor inflows is now channelled into the debt rather than equity market (Chandrasekhar and Ghosh, 2014). Investors are clearly cashing in on the much higher interest rate in India than elsewhere and the impact that has on overall financial returns.

Reducing interest rates can have a damaging impact on these inflows and it is hard to believe that the RBI has not factored this into its decision on interest rates. When, in May 2013, the Chair of the US Federal Reserve announced that it would soon begin tapering out its monthly US$ 70 billion bond and securities purchase programme, foreign investors in emerging markets began pulling out, expecting a rate rise in the United States. India too was affected. Compared with average monthly net inflows of US$ 3.97 billion during the first five months of 2013, India was hit by average net outflows of US$ 4.34 billion over June, July and August. The result was a sharp depreciation of the Indian rupee and fears that corporates exposed to foreign currency debt would find themselves in financial difficulty. Fortunately, the panic only lasted for three months. But that experience led to the Governor of the RBI calling for greater coordination when the taper actually began. If he can express concerns about the impact that the US taper and the consequent rise in US interest rates can have on investment flows to emerging markets like India, he is bound to have been likewise concerned about the impact that lower interest rates in India could have on such flows. This, then, may be an important, if not the sole, influence on the RBI's monetary policy stance.

Thus, inflation targeting and the prevention of large capital outflows are among the reasons that could explain the RBI's apparent preference for a high interest rate regime. In recent times the RBI has opted for a high nominal interest rate regime for a longish period. In fact, taking a longer view, apart from the period 2009-10 when the Government was responding to the effects of the global crisis, the benchmark nominal interest rate has been relatively high for much of the last decade. The impact of this on growth is likely to impact on employment growth as well.

## 3.3 Exchange rate management

The question that remains is whether the elimination of the monetized deficit actually results in central bank independence of the RBI. One consequence of liberalizing rules regarding cross-border flows of capital is that the economy is characterized by periods of surges of capital inflow into the country or capital flight out of the country, often influenced by developments abroad. In such a context, the Bank has no choice but to look to stabilizing the exchange rate. A surge in capital inflows would lead to currency appreciation and adversely affect trade competitiveness, and capital flight would result in currency depreciation that could result in bankruptcies of firms with foreign currency exposures or even a currency crisis. So the Bank must intervene.

Such volatility should not deflect attention from the fundamental tendency on the external front. India remains a deficit country, expending more foreign exchange on its current account transactions than the foreign exchange it earns. So if currency movements are influenced by the net value of current transactions, the rupee should be depreciating rather than appreciating. This is the long-term tendency in the external sector.

This implies that the factors explaining the rupee's fluctuations are largely related to the capital account, with periods of capital outflow or expectations of net capital outflow resulting in a depreciation of the rupee and periods or expectations of net capital inflow creating pressures for the currency to appreciate. The July-August 2013 depreciation was because of fears that the US Federal Reserve's decision to taper out its easy money policy would result in capital flight. At other times appreciation has been the problem.

Yet it would be wrong to say that the desire for a competitive exchange rate results in significant asymmetry in the RBI's response to rupee appreciation as opposed to depreciation. This, too, is partly the result of the level of the exchange rate being determined, not by fundamentals, but by flows on the capital account. If some factor triggers rupee depreciation, the exit of investors not wanting to lose out from that depreciation can set off a downward spiral. This presages not just a currency crisis, but bankruptcies in the corporate sector, because of exposures to foreign borrowing facilitated by liberalization and low interest rates abroad, not all of which are hedged.

Managing volatility in this fashion erodes the independence of the Reserve Bank and its control over the monetary lever. The implications are best illustrated by an example of currency appreciation. In India's liberalized foreign exchange markets, excess supply leads to an appreciation of the rupee, which in turn undermines the competitiveness of India's exports. Since improved export competitiveness and an increase in exports is a leading objective of economic liberalization, the persistence of a tendency towards rupee appreciation would imply that the reform process is internally contradictory. Not surprisingly, the RBI and the Government are keen to dampen, if not stall, appreciation. The Reserve Bank is forced to intervene by buying up foreign exchange in the open market to stall the appreciation, leading to reserve accumulation. Thus, its holding of foreign currency reserves rises as a result of large net purchases during periods of surge.

Increases in the RBI's foreign exchange assets amount to an increase in reserve money and therefore in money supply, unless the Bank manages to neutralize the increased reserve holding by retrenching other assets. If that does not happen the liquidity overhang in the system increases substantially, affecting the Bank's ability to pursue its monetary policy objectives. Until recently, the RBI has been avoiding this problem through its sterilization policy, which involves the sale of its holdings of central government securities to match increases in its foreign exchange assets. But even this option runs out, since the Bank is no longer accumulating its stock of government securities following the ban on central government borrowing from it.

There are two consequences of these developments. First, the Reserve Bank's monetary policy, now delinked from the State's fiscal policy initiatives, with adverse consequences for the latter, is no longer independent. More or less autonomous capital flows influence its reserves position and therefore the level of money supply, unless it chooses to leave the exchange rate unmanaged, which it cannot. This implies that the Reserve Bank is not in a position to use the monetary lever to influence domestic economic variables, however effective those levers may be.

A partial solution to this problem was the Market Stabilization Scheme (MSS) introduced in 2004. Under the MSS, the Government agreed to allow the Reserve Bank to issue treasury bills and dated securities, the proceeds of which are held in a separate identifiable account with the RBI and can be used only for redemption of those securities.

When the securities are out in the market, they are serviced in the normal way, with the interest charge being financed from the central budget. This increases the interest burden on the budget as a means of resolving the sterilization problem.

The second consequence is that when the RBI accumulates foreign currency reserves, the country is subject to a drain of foreign exchange, inasmuch as there are substantial differences between the repatriable returns earned by foreign investors and the foreign exchange returns earned by the RBI on investment of its reserves in relatively liquid assets. The real option, therefore, is either to curb inflows of foreign capital or encourage outflows of foreign exchange.

# 4. Implications for the labour market

## 4.1 General implications

It is to be expected that a regime with a conservative macroeconomic stance of the kind discussed above would affect growth in output and employment. The effects were not so visible over the last two decades because of the delay in actually implementing the prescribed fiscal deficit targets, and because an easy money policy stimulated demand, leading to high growth in the short term.

Ultimately, however, with output growth limited by this stance, employment growth would also be adversely affected. Aggregate rates of employment growth in India have been disappointingly low. The period since the early 1990s has been marked by stagnation of formal employment growth, despite accelerated output growth, because of the lower intensity of employment in the most dynamic manufacturing and services subsectors. The most rapidly expanding activities in terms of GDP share (such as the finance, insurance and real estate sector and IT-related services and telecommunications, which together now account for nearly 20 per cent of GDP) still employ less than 2 per cent of the workforce. The persistence of the vast majority of workers in extremely low-productivity activities is thus inevitable. In fact, total employment (in terms of usual work status and including principal and subsidiary activities) rose faster when the economy was growing more slowly. That growth has tapered off considerably since 2004-05, with rural employment showing a decline in absolute numbers and urban employment growing by only 2.5 per cent annual compound rate between 2004-05 and 2011-12.

Employment growth is not influenced by absolute magnitude of growth alone, but also by the nature of that growth and the capital intensity and labour use associated with it. The capital intensity of domestic production is affected not only by changes in capital intensity within each sector, but by changes in the pattern of production towards more capital-intensive products and sectors. As Patnaik (2006) notes, a combination of high output growth and low employment growth, is a feature characteristic of many developing countries during the years when they opened their economies to trade and investment. This is because (i), with tastes and preferences of the elite in developing countries being influenced by the “demonstration effect” of lifestyles in the developed countries, new products and processes introduced in the latter very quickly find their way to the developing countries when their economies are open; and (ii) technological progress in the form of new products and processes in the developed countries is inevitably associated with an increase in labour productivity. Hence after trade liberalization, labour productivity growth in developing countries is exogenously driven and tends to be higher than hitherto, leading to a growing divergence between output and employment growth.

## 4.2 The role of credit

This tendency is exaggerated by the demand-side effects of financial liberalization. Credit has had an important role to play in the expansion of the market for manufactured goods during the years of reform, through a boom in housing and consumer credit. One consequence of financial liberalization and the excess liquidity in the system created by the inflow of foreign capital, has been the growing importance of credit provided to individuals for specific purposes such as purchases of housing property, consumer durables and automobiles of various kinds.

An important implication of debt-financed manufacturing demand is that it is inevitably concentrated, in the first instance, in a narrow range of commodities that are the targets of personal finance. These commodities are more often than not the products of metal- and chemical-based industries and therefore tend to be both more capital-intensive and more import-intensive. Commodities whose demand is expanded with credit finance vary from construction materials to automobiles and consumer durables.

There are a number of other reasons why manufacturing production sucked out by a credit boom tends to have these characteristics. First, a more liberal policy on foreign direct investment has meant that much of the credit-financed, "new" market for manufactures is catered to by transnationals, endowing these products with a greater degree of import-intensity. This tendency has been helped along by the fact that those favoured with credit are the middle classes, characterized by a pent-up demand for foreign goods that could not be satiated earlier, not just because of protection but also because they lacked the means (including credit) to acquire these commodities rapidly. Any increase in the import-intensity of domestic production reduces the share of domestic value added and the extent of domestic linkages in most commodities, with potential negative effects for the employment elasticity of output growth.

A second reason why the linkage of domestic and employment effects would tend to be low, is that a combination of import competition, the induction of larger firms into the small-scale sector through the redefinition of "small", liberalization of imports of commodities that compete with those reserved for small-scale production and "dereservation" of areas earlier reserved for small-scale producers, has undermined the ability of smaller firms to service certain markets. Further, with the end of the era of development banking in general and directed credit in particular, the possibility of such firms obtaining the finance needed to emerge and survive has declined.

## 4.3 The importance of manufacturing

This, however, is not to say that manufacturing growth does not matter when considering the issue of generating more and better jobs. In fact it does, because of the direct employment generated by manufacturing and the foundation it provides for the growth of the services sector. Moreover, organized and "formal" manufacturing sets the bar for the level to be attained by wages and conditions of work. What is needed is broad-based industrial development including the development of sectors with positive externalities. It is here that another consequence of narrowing the focus of the central bank is visible.

In the years after independence, when India embarked on planned developed within the framework of a mixed economy, the RBI played an important role in shaping the financial sector as an instrument for development. Possibly drawing lessons from the German and Japanese experiences, the Government not only set up a large and diverse development banking infrastructure, but supported it with resources from the budget and the Reserve Bank.

With a view to supporting various term-financing institutions, the RBI set up the National Industrial Credit (Long-Term Operations) Fund from 1964-65. The post-1972 period witnessed a phenomenal rise in financial assistance provided by these institutions (including investment institutions), and the assistance disbursed by them rose to 10.3 per cent of gross capital formation in 1990-91 and 15.2 per cent in 1993-94. Given the nature of and the role envisaged for the development finance institutions (DFIs), the Government and the RBI had an important role in providing them with resources. In addition, public banks, the Life Insurance Corporation of India (LIC) and the General Insurance Corporation of India (GIC) also played a role (Kumar, 2013).

However, with the balance of payments crisis of 1991 triggering a major financial liberalization effort, a decline in development banking followed. Domestic and foreign private institutions that were now given greater scope objected to the provision of concessional finance to the DFIs as a source of unfair competition, which kept them out of areas that they were now looking to enter. The resulting pressure to create a "level playing field" – to which the Government succumbed, as reflected in the Narasimham Committee reports of the 1990s (especially Narasimham, 1998) – triggered a process through which the leading development financial institutions were transformed into commercial banks – the Industrial Credit and Investment Corporation of India (ICICI) in 2002 and the Industrial Development Bank of India (IDBI) in 2004. By 2011-12, assistance disbursed by the DFIs amounted to just 3.2 per cent of gross capital formation (Kumar, 2013; RBI, 2013: Tables 13 and 83).

Besides reflecting the shift to a more restricted mandate for the RBI, with a focus on inflation targeting, this withdrawal from an important financing space is bound to have adverse employment implications.

### 4.4 The public sector

Another consequence of the shift to a more conservative fiscal policy is that the public sector tends to shrink. Not only is there little investment through the budget in expanding the public sector, but parts of the pre-existing public sector are 'disinvested' or privatized to yield non-debt creating capital receipts. In addition, the Government increasingly relies on outsourcing of work so that poorly-paid contractual workers are substituted for workers earning reasonable salaries with benefits and permanent employment. By defining the organized sector as consisting of enterprises with 20 and more workers, or more than 10 workers in firms with an electricity supply, and all other units as unorganized, and formal employment as any employment "contract" involving any one of a written contract, social security (e.g. pension) and paid leave, the National Sample Survey (NSS) data for 2011-12 suggest that 25.6 per cent of workers in the unorganized public sector and 23 per cent in the organized public sector were 'informal workers'. These trends obviously affect the rate of employment growth in a sector that for long had recorded higher employment growth than the organized private sector. They also reduce the share of the labour force that has access to better terms and conditions of employment, thereby setting the standard that the rest of the economy should try to emulate. Thus, the decline of the public sector, stemming from conservative fiscal policies, does have adverse implications for employment growth and quality.

## 5. Concluding remarks

In summary, there is reason to believe that the macroeconomic stance adopted by the Finance Ministry and the RBI is not the best from the point of view of improving conditions in the labour market. Because of lower growth, changes in the stimuli driving growth and consequent changes in the composition of such growth, the responsiveness of employment to increases in output shrinks in the more formal segments of the economy. Much of the employment growth that occurs tends to be in the informal sector, with low wages and poor conditions of work. Given the low costs in this informal economy, the formal sector, too, starts retrenching, by outsourcing a range of activities to informal sector providers. Employment, wages and conditions of work are adversely affected, even in periods when the economy is registering high rates of growth. This feeds back to keep wages lower and conditions of work worse in the organized sector lower than they would otherwise be.

## 5.1 Fiscal policy

### *5.1.1 Activism versus sustainability*

The implication of this is that, on balance, fiscal policy should be proactive and monetary policy driven by objectives that include targeting a certain level of formal employment. This, however, is easier said than done. It has long been realised that the context in late-industrializing developing countries, with a large share of GDP originating from low-productivity agricultural and primary producing sectors employment, the bulk of the labour force is unusual from the point of view of designing fiscal policies. On the one hand, these countries are characterized by the presence of substantial unemployment and/or underemployment and significant amounts of unutilized capital equipment and natural resources. This should encourage them to adopt proactive fiscal policies financed from taxation and involving large deficits, if necessary, so as to enhance the level of employment and expand the volume of output. On the other hand, many of these countries face significant supply-side constraints in agriculture (especially those that have not implemented land reforms) and infrastructure. Opting for an expansionary fiscal policy could therefore result in inflation or balance of payments difficulties, which then subvert efforts to raise rates of growth in employment and output.

This, however, does not mean that the development strategy in these countries should not be based on an expansionary fiscal policy. State investment is crucial in many areas, such as physical and social infrastructure, since the presence of external factors means that the private sector is not likely to invest at socially optimal levels. And state expenditure is needed to rapidly expand the domestic market for the non-agricultural sector through the direct demand it generates and its multiplier effects. Public investment increases demand in the short run and enlarges the capital base of the economy. The nature, direction and efficacy of such investment determine the short-run multiplier effects and long-term growth implications. The implication of these consequences of state spending is that public expenditure “crowds in” rather than “crowds out” private investment, contrary to what is often suggested in the literature. Of course, structural features such as technology choice, asset inequalities and institutional conditions still matter.

The Government must therefore devise ways of ensuring that government spending does not translate merely into inflation, but primarily has growth-enhancing effects. There are two ways in which this can be done. One is for state expenditure to be financed from private sector savings by relying on tax revenues, especially the more progressive direct tax revenues. The other is for the pattern of deficit-financed spending to be such that it is focused on investment aimed at relaxing crucial supply side constraints. This means that increased public spending generates additional output and employment rather than higher prices. An aspect of this is that deficit-financed spending, which is by definition accompanied by increased levels of fiscal deficit relative to GDP, should not be reflected chiefly in an increase in the revenue deficit, but in capital expenditures that help ease supply side constraints. Thus, there is a case for a fiscal deficit composed entirely of public capital investment, as long as the social rate of return from such investment exceeds the rate of interest.

Fiscal sustainability is necessary over the medium term. But there should be some flexibility with respect to fiscal targets, especially when the deficits are the result of productive public expenditure, and during economic downswings. Rigid short-run rules on fiscal deficits reduce the possibility of effective countercyclical policies by governments, which can be extremely important when external or internal causes generate domestic slowdown or recession. Developing country governments can use the fiscal stance to address short-run situations of excess capacity or cyclical downswing without inflationary effects.

### *5.1.2 Reforming the taxation system*

Ideally, the tax regime in a country like India should provide increased collection without disproportionately harming the poor or women or having other regressive effects. This entails:

- improving tax administration and enforcement by reducing exemptions and loopholes and spending more on tax collection;
- diversifying sources of tax revenue instead of relying predominantly on a single indirect tax such as VAT;
- relying on rule-based and non-discretionary tax instruments, which reduce corruption and transaction costs;
- increasing personal income tax collection from the rich and targeting luxury consumption;
- taxing capital, especially speculative capital movements, including through small transactions taxes in foreign exchange and capital markets; and
- using trade taxes creatively and flexibly to the extent permitted within the framework of existing trade agreements, in order to manage trade and the balance of payments as well as generate more revenue.

## 5.2 Monetary policy

It should also be noted that in the area of macroeconomic policy, the Indian authorities would be well advised to rely more on fiscal policies rather than monetary policies as is often recommended. This is advisable for a number of reasons. First, the belief that money supply can be easily “defined” and controlled is not warranted. Second, the notion that if it can be controlled it must be held back to combat inflation is based on assumptions about the relationship which ties the price level to money supply that cannot be sustained. Finally, to try and stimulate private investment and/or private consumption demand by reducing the policy interest rate may not work, as the responsiveness of investment or consumption to interest rate changes tends to be weak. A far better route to growth is to spur demand by ensuring broad-based income growth and using this demand as the lever to increase private investment.

Monetary policy should not only focus on price stabilization and inflation control, but should be an integral part of overall macroeconomic and development strategies (Muqtada, 2015). It should aim at expanding supply in strategic sectors, improving livelihood conditions in sectors employing a large proportion of the labour force such as agriculture, and generating more productive employment by providing institutional credit to small scale producers in all sectors.

Macroeconomic instability can stifle growth. But macroeconomic stability is only a necessary, but not a sufficient, condition for growth. In fact, periods of accelerated growth can be associated with moderate inflation when supply constraints are encountered. When this happens, the focus of policy makers must be:

- to prevent inflation from becoming excessive by addressing actual and potential supply bottlenecks, and correcting sectoral imbalances that may add to inflationary pressure, such as in agricultural production;

- to ensure that the growth process is not adversely affected by policies to control inflation;

- to counter possible regressive effects of inflation through specific measures directed at the poor, such as public provision of certain basic needs; and

- to ensure that inflationary expectations and speculative tendencies are not built up in the system, thereby causing higher rates of inflation over time.

To sum up, an alternative to inflation targeting is a macroeconomic strategy that targets real variables, such as aggregate growth, productive investment, employment generation or poverty reduction. Monetary policy must be part of the overall macroeconomic policy directed towards these targets, and should be aligned to and accommodate fiscal and exchange rate policies. This means that interest rate management will not suffice, and other instruments must be used by the central bank, including directed credit. Policy makers should avoid excessive rigidity with respect to any one target and be prepared to be flexible in adjusting targets and instruments depending upon the requirements of changing situations.

## 5.3 The role of automatic stabilizers

In addition, in order to regulate economic activity over the course of a cycle, fiscal and monetary policies must provide some "automatic stabilizers" such as:

- progressive taxation, which reduces the negative fiscal impact on the poor.

- welfare programmes and social protection policies, including unemployment insurance schemes, worker protection, special access to non-collateral based credit, public distribution systems for food and other necessities, and income support for female-headed worker households. These ensure that consumption does not fall as much as it otherwise would during a downswing.

- automatic adjustments of tariffs to external prices, such as a variable tariff system.

- pension plans that do not involve defined contributions, since such programmes may lead to more volatility in consumption in response to stock market shocks.

Automatic stabilizers are important in times of downswing, which are of course particularly important in the current conjuncture. But there are also ways of responding to booms, such as:

- a counter-cyclical tax, such as an export tax, that allows the Government to generate more revenue during export booms, to be set aside for a price stabilization fund for future exports;

- a tax on capital inflows, limited to, say, equity and portfolio capital, as opposed to "green field" investment, when such inflows are excessive; and

- restricting activities associated with speculative bubbles, through measures such as imposition of higher capital gains taxes and bank regulations that reduce lending for such activities.

A bundle of macroeconomic policies of this kind, by restoring the central role of government in driving growth, can ensure that the cycles and recession characteristics of predominantly market-driven systems are moderated and managed, with attendant positive effects on labour market outcomes such as employment levels and conditions of work.

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