Asian Perspective on Growth: Outlook for India[1]

Distinguished friends,

I am delighted to be here at the G30's International Banking Seminar hosted by the Monetary Authority of Singapore. Indeed, it is an honour and privilege to be amidst the global Gurus of financial world. I divide my humble presentation into five parts: namely the contours of Indian economy; the major challenges facing the Indian economy; the impact of global imbalances on India; some not easily quantifiable strengths of India and; India's growing economic relations with Asia.

Contours of Indian Economy

- The Indian economy has been growing at an average annual growth rate of nearly 6 per cent since the 1980s, and at over 8 per cent during the last three years. A Draft Approach Paper to the Eleventh Five Year Plan (2007-08 to 2011-12) suggests that the economy can grow between 8 and 9 per cent per year.
- India has also shown considerable resilience during the recent years and avoided adverse contagion impact of several shocks.
- The inflation rate has been low and stable since the mid-1990s moderating to around 5 per cent per annum. The common intention of the Government and the Reserve Bank of India is to maintain annual inflation below 5 per cent in the medium term.
- We see a consistent increase in gross domestic investment rate from 23.0 per cent of GDP in 2001-02 to 30.1 per cent in 2004-05. The gross domestic saving rate has also improved from 23.6 per cent to 29.1 per cent over the same period, contributed by a significant turn around in public sector saving.
- The productivity of capital use, as measured by the Incremental Capital Output Ratio (ICOR), has been high by Asian standards and is showing downward trend reflecting improvement in productivity growth as well as more intensive use of existing capacity. This point to prospects for sustained high growth in future, given the existing level of investment in the economy, coupled with upward trend in domestic savings.
- A noteworthy development during the recent years has been the continued recovery in manufacturing sector. This has been supported by domestic as well export demand, increased capacity utilization, augmentation of capacities and improvements in private business and consumer confidence.
- The services sector accounts for 60 per cent of GDP and has been growing at 9 per cent per annum since the mid-1990s, with potential for creating jobs and generating additional income.
- There has been a significant decline in the poverty ratio during the 1990s as reflected in the latest survey of 2004-05 by the National Sample Survey Organisation. The growth performance and potential augurs well for

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[1] Address by Dr. Y.V.Reddy, Governor, Reserve Bank of India at the G30's International Banking Seminar on September 18, 2006 hosted by the Monetary Authority of Singapore in Singapore.

addressing concerns relating to disguised unemployment, seasonal unemployment and underemployment in the years ahead.

- The fiscal position of the Government, both central and States, is undergoing consolidation in terms of targeted reduction in fiscal deficit indicators.
- The current account deficit (CAD) to GDP ratio has been moderate in India. The current account remained in surplus during 2001-02 to 2003-04, before turning into a modest deficit since then. It is expected to continue to be in the range of 2 to 3 per cent under the projected outlook of 8 to 9 per cent growth rate during the Eleventh Five Year Plan. India's foreign exchange reserves now stand roughly at US $ 165 billion and are well in excess of total external debt of the country.
- The financial markets, especially the money, government securities and forex markets have been nurtured and developed in view of their critical role in the transmission mechanism of monetary policy.
- The financial sector has acquired greater strength, efficiency and stability by the combined effect of competition, regulatory measures, policy environment and motivation among the market players including banks.
- The workers enjoy considerable freedom of movement, expression and rights, especially through unionisation which, while making some changes difficult, ensures a vibrancy and timely improvisation to deal with competition.

Major Challenges for Sustenance of Indian Growth Process

- First, the poor state of the physical infrastructure, both in terms of quantity and quality. The most important issue here is regulatory framework which is being addressed by the Government. Technological developments and rapid enhancement of domestic construction capabilities should aid the process of speedy and efficient implementation. Given the healthy fundamentals of the domestic financial sector and the enhanced interest of foreign investors, funding should not pose any serious problem. One other concern has been the cost recovery, which is expected to improve with more public-private partnership. There are grounds for optimism for a medium term resolution of these issues.
- Second, fiscal consolidation. The recent budget of the central government brings the consolidation on track, targeting a gross fiscal deficit of three per cent of GDP by 2009 while eliminating revenue (current) deficit. Our studies on State finances in Reserve Bank of India give grounds for optimism in regard to their fiscal health. We recognize two important areas which will result in fiscal empowerment. One is elimination of subsidies which are not appropriate, and elimination of tax exemptions, which are distortionary. While in any polity fiscal consolidation is hard, it is particularly so in our setting, but there are grounds for optimism.
- Third, and perhaps the most challenging issue relates to development of agriculture. While over 60 per cent of the workforce is dependent on agriculture, the GDP growth generated from agriculture is only marginally above the rate of growth of the population, which is not adequate to ensure rapid poverty reduction. To facilitate a more rapid growth in agriculture, legislative, institutional and attitudinal changes to supplement enhanced public and private investment are needed. There is an increasing recognition of this issue among policy makers.

- Fourth, there is a need to shift the emphasis to attracting foreign direct investment, which is less volatile. This requires a more favourable investment climate in general both for domestic and foreign capital.
- Fifth, delivery of essential public services such as education and health to large parts of our population is a major institutional challenge. It is strongly felt that education will empower the poor to participate in the growth process and the large gaps in availability of health in terms of minimum access to the poor needs to be filled.
- With rapid growth in manufacturing and services, a sudden and intense pressure has developed in regard to availability and quality of urban infrastructure and urban services. A notable beginning has been made in this direction with the launching of "National Urban Renewal Mission".

Implications of Global Imbalances for India

- India has not contributed either positively or negatively in terms of large current account surplus or large current account deficit; saving-investments have been by and large balanced; the economy is domestic demand driven and generally our policies, including exchange rate are market oriented. Thus, India has been following policies which not only served it well but also contributed to global stability.
- Any large and rapid adjustments in major currencies and related interest rates or current accounts of trading partners would impact the Indian economy though the impact on India may be less than many other emerging market economies.
- India does not depend on the international capital market for financing the fiscal deficit and consequently to some extent adverse consequences of the global developments would be muted. However, there could be a spill-over effect of global developments on domestic interest rates and thus on fisc also.
- Any abrupt adjustment in global imbalances may have some impact on the corporates, banks and households in India though their exposures, in aggregate, to external sector are not huge. With respect to the impact on corporates, if there is widening of spreads due to a shift in investor confidence in the international markets, those corporates which have borrowed at variable rates may possibly suffer more than those, which have taken loans on a fixed rate basis.
- Though, banks' exposure to the risky assets has been severely restricted by Reserve Bank’s regulatory actions, should there be a reversal of capital flows, asset prices may decline. Further, banks in India have invested significantly in government debt and other fixed income securities. If a rise in international rates gets reflected in domestic interest rates, banks will have to mark down the value of their investment portfolio. However, the banking sector has acquired some added strength to absorb such probable shocks, largely aided by regulatory actions.
- As regards impact on the households, there is a risk that rise in interest rates in general could impact the housing market and expose the balance sheet of the households to interest rate risk, increasing the risk of loan losses for banks. The overall banking sector’s exposure to housing loans being relatively

small, adverse developments may not have any systemic implications on the banking sector.

Not Easily Quantifiable Strengths

- First, a vast pool of science and technology graduates and the millions who are familiar with English language are sources of strength for the emerging India so far. The familiarity with multiple languages in India prepares the people to adapt better to multi-cultural situations, making it easier for them to fit into international systems very smoothly. There is also recognition of the need to maintain and enhance quality of research and skills.
- Second, impressive are the initiatives of many States for empowerment of women which defend their rights and help to gain greater self-esteem and control over their own personal lives and social relationships.
- Third, the existence of a free press provides some insurance against excesses and makes Governments at all levels more accountable than otherwise. The recently enacted Right to Information Act has contributed to credibility of transparency in public policies. Thus, Indian democracy and media are active and vital to our nation.
- Fourth, the political climate is characterised by what may be termed as political system stability, despite the coalition cabinets and periodic elections both at the Centre and several States. As Michael Mandelbaum, a democracy expert at Johns Hopkins University in Washington said:

  > "There's a lot of turmoil on the surface of Indian democracy, but there's a lot of consensus deep down in the political system."

- Fifth, India will remain one of the youngest countries in the world in the next few decades. This "demographic dividend" is seen as an inevitable advantage provided prerequisites such as skill-upgradation and sound governance to realize it are put in place. More important, the demographic transition is likely to be stretched over a longer period since States in India are at different stages of such transition from Kerala to Uttar Pradesh.
- Sixth advantage is India's business culture. In terms of business environment, the impressive growth coupled with market orientation of the economy has been a bottoms-up exercise, with a very broad-based growing entrepreneurial class. These tendencies are perhaps reflective of a penchant for innovation among growing entrepreneurial class in India, imbued with professionalism and seeking to be globally competitive.
- Seventh, there is increasing enthusiasm amongst the provincial governments to attract foreign investment and hence we can hope that they will be keen to ensure physical infrastructure and good governance.

Let me conclude with what Mr. Edward Luce who was with the Financial Times in India has to say about India in his latest book "Inspite of the Gods: The Rise of Modern India"

> "India is not on autopilot to greatness. But it would take an incompetent pilot to crash the plane"

Economic Relations with Asia

- China and India are not only helping the global economy in producing low-cost goods and services but are also rapidly growing markets in their own right, with a huge demand for consumer and capital goods produced all over the world. In the context of on-going buoyancy in the Asian region and the increasing trade between developing countries, India's trade relation has undergone a significant structural change, with developing economies in general and Asia in particular, accounting for a major share of India's merchandise trade. In terms of non-oil imports, China has become the largest trading partner for us.

- Asia accounts for nearly half of India's foreign trade, excluding oil imports and is growing. Exports to Asia accounted for 46 per cent of India's total exports, while non-oil imports from Asia accounted for 45 per cent of India's total non-oil imports during 2005-06. China has emerged as the third major export destination after US and UAE. India's total trade (merchandise exports and non-oil imports) with Asia has increased from US $ 29 billion in 2000-01 to US $ 91.5 billion in 2005-06, comprising exports at US $ 47.2 billion and non-oil import at US $ 44.3 billion.

- Total trade with the ASEAN (exports plus non-oil imports) has increased manifold from US $ 6.7 billion in 2000-01 to US $ 21.1 billion in 2005-06. India's exports to the ASEAN region stood at US $ 10.5 billion and imports at US $ 10.6 billion during 2005-06.

- India has become a formal dialogue partner of ASEAN, and is keen to expand its participation in Southeast Asian and Asia-wide institutions. Similarly, India's trade with SAARC countries which presently stands at about at US $ 6.7 billion has vast scope to expand further.

- In order to boost regional trade and investment, India has entered into comprehensive economic cooperation agreements/trade agreements with several countries including China, Japan, Korea, Singapore, Thailand, Maldives, Bhutan, Bangladesh, Nepal, Sri Lanka and regional blocks such as ASEAN.

- Mr. Raymond Lim, Singapore's Minister of Transport and Second Minister of Foreign Affairs, in his article "Creating Globally Connected Asian Community" which appeared in the June 2006 issue of Finance and Development of the IMF notes:

  > "The rise of China and India will redefine regional divisions of labour and trade and help the Southeast Asian economies take off on a new and higher growth trajectory. China and India will bring Asia into the center of the global economy. ….. The rise of China and India is helping Asia to not only grow but to become more integrated."
