The Indian Economy: Opportunities and Challenges[1]

I am honoured to be invited to Nomura's 40th Central Bankers Seminar. The discussions here assume topical relevance in the context of the tectonic shifts underway in the global economy that present new challenges for the conduct of central banking. Besides divergent growth pathways and the varying speeds and magnitudes of disinflation, regime shifts impart their own layers of uncertainty.

In the parlance of the game of cricket, with which India is seen as synonymous and this also true of the game of baseball, there is a spot in the middle of the blade of a bat from which the ball rebounds with maximum acceleration and minimal vibration in the batter's hands to usually race across the field or sail over it. It's called the sweet spot. The Indian economy is at a sweet spot in its evolution. Real GDP is growing at the fastest pace among major economies. Inflation is approaching its target *albeit* unevenly. The external balance sheet is stronger than ever before, underpinned by ebullient capital inflows, a modest current account deficit and large foreign exchange reserves. Fiscal consolidation is into its third consecutive year after the pandemic. The corporate sector has deleveraged and is poised to launch a new cycle of capital investment. The financial sector is sounder and more resilient, as it prepares for intermediating the resource requirements of a rising growth trajectory over the next few decades. Reflecting these developments, financial markets

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[1] Keynote Address delivered by Michael Debabrata Patra, Deputy Governor, Reserve Bank of India (RBI) at the Nomura's 40th Central Bankers Seminar on March 25, 2024 at Kyoto, Japan. Valuable comments received from Harendra Behera, Binod B Bhoi, Asish Thomas George, and editorial help from Vineet Kumar Srivastava are gratefully acknowledged.

are ignited with robust optimism even as investors are already positioning themselves to buy into the unfolding India narrative.

Against this backdrop, I thought I would present to you a few facets of the state of the Indian economy, some exciting opportunities and the main challenges to India's aspirational goals. In the interest of time, I will be selective rather than enumerative. For instance, I will not speak of the transformative social change that is taking place in lifting 415 million (the combined population of the US and Japan) of its people out of poverty between 2005 and 2021, or the world leadership India has already attained in the production of a wide range from various agricultural commodities to tractors to smartphones to IT services, digital payments and satellite launching space technology.

The State of the Economy

India's growth trend is on the cusp of a post-pandemic upshift, with early signs of it rising above 7 per cent recorded during the 2000s before COVID-19 struck. While private consumption typically accounts for about 60 per cent of India's GDP, it is investment and exports that provide the turning points. In the period 2021-24, the export lever has been muted by global headwinds, but public expenditure on infrastructure is taking over as the locomotive of the step-up in the growth trend. Recent surveys indicate that private investment is getting crowded in.

India's recent growth performance has surprised many, triggering a flurry of upgrades. For instance, the International Monetary Fund (IMF) has cumulatively revised its forecast for 2023 upwards by 80 basis points between April 2023 and January 2024. In its latest update, it expects India to contribute 16 per cent of global growth, the second largest share in the world in terms of market exchange rates by which metric, India is the fifth largest economy in the world and positioned to overtake Germany and Japan within the ensuing decade. In purchasing power parity (PPP) terms the Indian economy is already the third largest in the world. According to the OECD's December 2023 update, India will overtake the US by 2045 in PPP terms to become the world's second largest economy. This underlying strength will also be reflected in the PPP value of the Indian rupee (INR).

Opportunities

In this setting, let me cite a few tailwinds that will likely power India's take-off.

First, demographics favour the rising profile of growth. Currently, India has the world's largest population and the youngest. The median age is around 28 years; not until the mid-2050s will aging set in. Thus, India will enjoy a demographic dividend window of more than three decades, driven by a rising working age population rates and labour force participation rate. This is a striking contrast to a world widely confronted with the challenge of aging.

Second, India's growth performance has been historically anchored by domestic resources, with foreign savings playing a minor and supplementary role. In fact, India bears out the puzzle of high correlation between domestic saving and investment rates that was observed by Martin Feldstein and Charles Horioka way back in 1980. This is also reflected in the current account deficit (CAD) which remains within a sustainable threshold of about 2.5 per cent of GDP. Currently, the CAD averages about 1 per cent and this is associated with various indicators of external sector resilience – illustratively, external debt is below 20 per cent of GDP and net international investment liabilities are below 12 per cent. Debt servicing absorbs less than 7 per cent of current receipts, with principal repayments due over 12 months accounting for less than 48 per cent of international reserves. Reflecting these innate strengths, the INR has been among the least volatile currencies in 2023; it has, in fact, been appreciating in both nominal and real terms during the early part of 2024.

Third, the response to the COVID-19 pandemic through a large fiscal stimulus took the general government fiscal deficit to 13.1 per cent of GDP and public debt to 89.3 per cent of GDP in 2020. A gradualistic path of fiscal consolidation was adopted beginning 2021-22 that has brought the general government deficit to 8.6 per cent of GDP and public debt to 81.6 per cent of GDP by March 2024. Employing a dynamic stochastic general equilibrium (DSGE) model, it is estimated that reprioritising fiscal spending by targeting productive employment-generating sectors, embracing energy-efficient transition and investing in digitalisation could lead to a decline in general government debt to 73.4 per cent of GDP by 2030-31. In contrast, the debt-GDP ratio is projected by the IMF to rise to 116.3 per cent in 2028 for advanced economies and to 75.4 per cent for emerging and middle-income countries.

Fourth, India's financial sector is predominantly bank-based. In 2015-2016, the overhang of asset impairment in the wake of the global financial crisis and the ensuing years was addressed through a deep surgery in the form of asset quality review (AQR). A massive recapitalisation was undertaken during 2017-2022. The beneficial effects started to show up from 2018 – gross and net non-performing assets ratios declined to 3.9 per cent and 1 per cent, respectively, by March 2023, with large capital buffers and liquidity coverage ratios well above 100 per cent. An Insolvency and Bankruptcy Code (IBC) has created the institutional environment for addressing stress in banks' balance sheets. On-site supervision is complemented with off-site surveillance, which harnesses SupTech, big data analytics and cyber security drills. More recently, a virtuous credit upswing has taken root alongside a strong improvement in bank profitability. Stress tests for credit risk and interest rate risk reveal that banks would remain above minimum capital requirements even under severe stress scenarios. Macroeconomic and financial stability are providing the foundation for medium-term growth prospects.

Fifth, India is undergoing a transformative change leveraged on technology. The trinity of JAM – Jan Dhan (basic no-frills accounts); Aadhaar (universal unique identification); and Mobile phone connections – is expanding the ambit of formal finance, boosting tech start-ups and enabling the targeting of direct benefit transfers. India's Unified Payment's Interface (UPI), an open-ended system that powers multiple bank accounts into a single mobile application of any participating bank, is propelling inter-bank, peer-to-peer, and person-to-merchant transactions seamlessly. Payment systems in India operate on a 24 by 7 by 365 basis. Functionalities like offline payments, feature phone payments and conversational payments have been incorporated. The internationalisation of the UPI is progressing rapidly.

Sixth, inflation in India is moderating after surging on multiple and overlapping supply shocks from the pandemic, weather-induced food price spikes, supply chain disruptions and global commodity price pressures following the Russia-Ukraine conflict. Notably, however, inflation in India peaked early in response to coordinated monetary-fiscal policies to anchor inflation expectations and dissipate idiosyncratic food price pressures. As a result, inflation has fallen back into the tolerance band since September 2023, with core inflation steadily ebbing to even below the target. The coordinated approach allowed the RBI to look through the first-round effects of food price shocks so that supply management balanced supply with demand. This minimised the financial stability and growth risks of monetary policy tightening.

Challenges

India has emerged from the pandemic scarred but resilient and poised to make a tryst with its developmental ambitions by riding the thermals that these opportunities are generating. Take-off will have to contend with the headwinds posed by several challenges. Again, I propose to be selective in the interest of time.

Reaping the demographic dividend hinges around expanding the contribution of the workforce to GDP growth. Currently, the contribution of labour to value added in India compares poorly in a cross-country perspective – in terms of appropriate skills for a specific job, only 51 per cent is employable, highlighting the criticality of the upskilling missions that are underway such as Skill India that aims to bridge the skill gap and enhance employability. Startup and entrepreneurship support initiatives foster innovation and job creation. Digital transformation through the Digital India campaign opens up new avenues for employment. Rural employment programmes and women empowerment schemes also promote the contribution of labour to value added. More than 80 per cent of the workforce is employed in the informal sector, which I shall address shortly. Furthermore, India ranks low in women's participation in the workforce[2]. Increasing female labour participation is a key challenge, needing social norms in favour of working women; incentivising diversity in educational institutions and work places; flexible working hours and

[2] According to the World Bank (World Development Indicators), India ranked 170 among 186 countries in terms of the Female Labour Force Participation rate in 2022.

women friendly policies and facilities at work places; and promoting work-life balance – metaverse[3] may offer exciting opportunities.

A qualified labour force contributes best when supported by high quality infrastructure. India's per capita investment in infrastructure at US $ 90.6 in constant 2015 dollars terms in 2020 needs to be scaled up by lifting infrastructure investment growth from around 3.5 per cent to at least 6 per cent to achieve world class standards. This will require transparent regulations, faster clearances, smooth land acquisition and climate clearance policies, and adequate finance. The sustained infrastructure spending and logistics push across successive union budgets is creating the environment for financing India's infrastructure goal. Infrastructure creation has been a key focus of public policy, with flagship schemes like the National Infrastructure Pipeline (NIP) and PM Gati-Shakti Mission, complemented by a jump in the share of public investment in total investment 2015-16 onwards. Sub-national governments and the private sector have also been empowered through interest free loans for capex and through the Production Linked Incentive (PLI) Scheme to step up their capital expenditure. The infrastructure push encompasses roads, railways, ports, electricity, digital infrastructure, and rooftop solarisation.

The essence of expanding the role of the workforce in India's future lies in the formalisation of jobs, which bring the role of the manufacturing sector to centre-stage. India largely bypassed manufacturing in its developmental journey - services account for two-thirds of India's economy today. India's manufacturing sector as a proportion to GDP (in constant 2015 US dollar terms) remains much below the world average. Since the 1990s, the average growth of manufacturing has been 7 per

[3]The metaverse refers to virtual worlds in which users represented by avatars interact usually in 3D, facilitated by the use of virtual reality (VR), augmented reality (AR) headsets and blockchain technology.

cent[4]. With 8.5 per cent growth, manufacturing's share would rise to 20 per cent of GVA by 2030-31, and to 25 per cent if the growth rate can be pushed up to 12.5 per cent – making India a global manufacturing hub with forward and backward linkages for other sectors of the economy. To achieve this, India must adapt to the fourth industrial revolution (automation; data exchange; cyber-physical systems, the Internet of things; cloud computing; cognitive computing and creating the smart factory, advanced robotics). A skilled labour force will hold the key.

India's manufacturing and services must find expression in global markets – make in India for the world. Intensified efforts need to be made to raise India's exports of goods and services from US $ 768 billion or 2.4 per cent of the world total to US $ 1 trillion each for merchandise and service exports or 5 per cent of the global total by 2030. The potential exists in the form of sectors such as IT and digital services, value-added agricultural products; high-value tourism; financial services; retail and e-commerce. Global Capability Centers (GCCs) are already exploiting this potential by offering unique opportunities to multinational enterprises (MNEs) to lead product innovation, drive technological advancements, create next-gen intellectual property (IP) and spearhead digitalisation initiatives on a global scale. India is preparing for this export thrust through initiatives such as its production-linked incentive scheme, districts as export hubs; and by supporting the export potential of micro, small and medium enterprises (MSMEs).

As India emerges as an export powerhouse backed by a strong manufacturing base, a natural corollary will be the full internationalisation of the Indian rupee. Several factors are already in place. The Indian diaspora is the biggest in the world and India is the top recipient of

[4] Current share of manufacturing is 17 per cent.

remittances. The Indian rupee trades three times more offshore than onshore. India has local currency settlement arrangements with several countries in Asia and the middle east and interlinking of payment systems is underway. Deep and liquid financial markets are developing. The international financial centre in GIFT city, Gujarat is emerging as global financial and technology hub with a thriving financial ecosystem. The imminent inclusion of Indian sovereign bonds in global bond indices is also likely to spur demand for exposure to India. The policy emphasis on macroeconomic and financial stability is also a positive for the INR. If the INR's turnover equals the share of non-US non-Euro currencies in global forex turnover (4 per cent), the INR will have arrived as an international currency.

The last challenge I will dwell upon is the greening of the Indian economy for sustainable development. At the Conference of the Parties 26 (COP26), India's commitment towards the environment by 2030 included: (i) 500 GW non-fossil energy capacity; (ii) energy mix comprising 50 percent renewable energy; (iii) reducing total projected carbon emissions by one billion tonnes; (iv) reducing the carbon intensity of its economy by 45 per cent; and (v) achieving net zero by 2070. It is estimated that a cumulative investment of US$ 10.1 trillion is needed along with adequate access to technology to meet the net zero target.

Conclusion

According to the distinguished British economist, Angus Maddison, who specialised in the measurement and analysis of economic growth and development, India was the largest economy of the world with the highest share in world GDP during 1 to 1000 AD. Over the next 600 years, India intermittently fell to the second position, but reclaimed the position of the world's largest economy by 1700 AD with a share of 24.4 per cent of world GDP. After that came the colonial rule and a long retrogression.

Given the innate strengths I described and the energies and transformation that are driving the nation to overcome its challenges and achieve its aspirational goals, it is possible to imagine India striking out into the next decade with a growth rate of 10 per cent. If this is achieved, India will become the second largest economy in the world not by 2045 as shown earlier, but by 2032 and the largest economy by 2050.

Thank you.