The Indian Economy: Review and Prospects*

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I am honoured to be invited to deliver this address today at the Metropolitan Chamber of Commerce and Industry, Dhaka. We, in the Reserve Bank of India, had the pleasure of receiving recently your delegation. On that occasion, I had accepted the invitation, in principle, to address this gathering. I am glad to be able to fulfil my assurance.

I have the honour of being associated, for over three decades, with several distinguished civil servants from Bangladesh – notable among those who continue to be close friends are Mr. Syeduzzaman and Mr. Gholam Kibria, former Finance Secretary Government of Bangladesh. I have had the privilege of working closely, among others, with respected Dr. Fakhruddin Ahmed, while he was the Governor of Bangladesh Bank, and also the current Governor, Dr. Salehuddin Ahmed – a well-known authority on microfinance issues.

My familiarity with the economy of Bangladesh is long and rather intimate. It dates back to my association with the Executive Director's office in the World Bank during 1978 to 1983, and more recently, as Executive Director on the Board of the IMF during 2002-03. Further, as the Deputy Governor of the Reserve Bank during 1996 to 2002 and as the Governor since 2003, I have the privilege of working with the Bangladesh Bank, with mutual trust and understanding in several fora such as SAARCFINANCE Group and Asian Clearing Union (ACU). In fact, I came to Dhaka to attend the annual meeting of the ACU whose Chairmanship is currently with Dr. Salehuddin Ahmed of Bangladesh Bank.

* The speech delivered by Dr. Y V Reddy, Governor, Reserve Bank of India at the Metropolitan Chambers of Commerce and Industry, Dhaka on May 17, 2007 at the Chamber Building, 122-124, Motijheel CA, Dhaka, Bangladesh.

One of the great contributions of your country to the global community is the demonstration of what voluntary and selfless service can achieve in poverty alleviation and restoration of appropriate personal dignity to every citizen: the slogan is “credit as a right’. We, in the Reserve Bank, are grateful to Professor Muhammad Yunus for having accepted our invitation to visit us and address us. Our Board, officers and staff have been inspired by his example and the address delivered by him with great passion and utmost sincerity.

Mr. President, as agreed in Mumbai when we met recently, I will share my thoughts on certain aspects of the Indian economy – randomly encompassing the recent past, the short-term outlook and the way forward.

Before doing so, perhaps, I should respond to some comments you made. Mr. President, in your address of welcome, you have been highly professional in assembling your thoughts for the occasion. More impressive, to my pleasant surprise, you sent me a copy of your proposed address on my arrival in Dhaka. So, I am under some moral obligation to respond to some of the observations you have made, specially in regard to the ACU and SAARCFINANCE Group.

SAARCFINANCE and ACU: Some Aspects

Mr. President, you made very important, indeed significant, general observations on monetary policy, on which we need to deliberate. I would like to refer to two sentences in your address:

“Mr. Governor, it is our view that with the exception of one or two, monetary policies in the South Asian countries are yet to be fully able to foster and help the growth process.”

and

“Monetary policies were of limited help to such achievements.”

We believe that monetary policies help the growth process in South Asia in three ways: first, by providing price stability; second, by ensuring financial stability; and third, by enabling availability of financial resources for an efficient growth process. Monetary policies do contribute significantly to the growth process but it is not fully appreciated. There is satisfaction when output and employment growth occurs and frustration when it stalls. When instability occurs, there is severe pain but the benefits of sustained stability – that is, the absence of instability – go largely unnoticed, taking it for granted. Sometimes, the efforts of the monetary authorities to assure stability may entail some short-term burdens for some of the segments of the economy, but the overall positive contribution of such measures to the larger population and to growth through stability may not be directly felt. For example, it can be argued that it was possible for the economies of South Asia to show impressive macro-economic achievements in the last five years, precisely because of the enabling monetary, financial and external sector environment, as managed by the central banks.

More specifically, in the case of India – and I believe, in most of the South Asian countries – our mandate encompasses both, growth and stability. We do not have a single overriding objective, such as an inflation target. But the relative emphasis in the policy varies from time to time, depending on the context. Let me give you an example. A few years ago, the Reserve Bank of India was encouraging expansion of bank credit, while, more recently, we are trying to moderate such expansion.

Mr. President, you made a strong case for greater monetary co-operation in South Asia. I do agree that there are close monetary linkages amongst South Asian economies and hence, greater harmonisation of monetary policies, specially through staff exchanges and exchange of information, would be useful. The point is well taken and I trust that all members of the SAARCFINANCE Group would give due consideration to such suggestions by the respective Chambers of Commerce and Industry.

Mr. President, you raised an interesting issue of harmonisation amongst trade, investment and financial integration. We, in the Reserve Bank, have a view on this. The view is that the trade integration is undeniably beneficial but financial integration has both, benefits and risks, at our stage of development. Capital, particularly the portfolio flow, is highly mobile, can easily reverse its direction and it is difficult to invoke the "rules of origin" in regard to such capital. Hence, we believe in a gradual process of fuller capital account liberalisation, while recognising the growing ineffectiveness of micro controls in a world of deep trade integration. Thus, the trade, investment and financial flows do go together, but in a somewhat harmonious as well as well-sequenced manner and not necessarily, in a simultaneous manner.

Finally, in the ACU and SAARCFINANCE Group meetings in Dhaka, the deliberations, by and large, reflected your sentiments, calling for greater co-operation, recognising the emerging global realities. Governor Salehuddin Ahmed has already briefed the media on major conclusions of the meetings. Since I formally took over the charge as the Chairman of the SAARCFINANCE Group in Dhaka, let me share with you one highlight of our exchanges in the meeting of the SAARCFINANCE Group.

We noticed that the South Asian region seems to be emerging, in the recent years, as a very dynamic economic hub. The growth has been impressive, inflation moderate in spite of the elevated prices of oil and foodgrains, and the external sector is stronger. There is a feeling that the prospects for the economies of South Asia appear brighter than ever before in history, with a potential to be amongst the most-rapidly growing economies of the world – while contributing to significant reductions in global poverty. I believe that the South Asian model has some inherent and unique strengths. The output growth and enhanced efficiency is led by domestic entrepreneurial class. It is private-sector-and business-led, though the public sector still dominates. It is decentralised and bottom-up. The growth is enabled by the public policies, banking system, capital markets, foreign direct investment, export demand, *etc.,* but the main thrust – the push and the pressure – is coming from the domestic entrepreneurship, domestic investment and consumption demand. Thus, there are good prospects that the growth in South Asia will be self-accelerating and reasonably stable. In this process, the Chambers of Commerce and Industry, like yours, have to be in the forefront of reforms and poverty alleviation.

I would like to end my response to your thoughts on this very optimistic note for South Asia, in general, and Bangladesh, in particular. I will now move on to narrate the prospects for the Indian economy.

Macroeconomic Performance: A Review

The average growth rate of the Indian economy over a period of 25 years since 1980-81 has been about 6.0 per cent, which is a significant improvement over the previous three decades when the annual growth rate was only 3.5 per cent. Over the last four years during 2003-07, the Indian economy has entered a high-growth phase, averaging 8.6 per cent per annum. The acceleration of growth during this period has been accompanied by a significant moderation in volatility, especially in industry and services sectors. In the past, the occurrence of even one of the shocks, either food or oil shock, would have produced a sharp loss of growth, balance of payments difficulties and perhaps, some financial disruption. Seen in this context, this robust macroeconomic performance, in the face of oil as well as food shocks, demonstrates the vibrancy and resilience of the Indian economy. In this context, it is important to note that India's growth is mainly driven by domestic consumption, contributing on an average to almost two-thirds of the overall demand, while investment and export demand are also accelerating. It must also be noted that over 95 per cent of investment during this period was financed by the domestic savings only.

The combined effects of these have given impetus to a sharp acceleration in the per capita GDP growth. For example, during the 1970s, the per capita income in India grew by 0.6 per cent, which implicitly meant that a person might not see doubling of his income even once in his lifetime. Since the 1990s, the per capita income has been growing at an average rate of around 4.0 per cent, implying that a person's income will double in nearly 18 years. A person with a life expectancy of, say, 72 years could thus see his income doubling at least three times in his adult life. If the current GDP growth rate of around 9 per cent is maintained, a person can hope to see the standard of living multiplying by almost five times in his lifetime.

There is evidence of ongoing improvements in total factor productivity and the efficiency of capital use. Thus, while there are cyclical factors underlying the current growth momentum, there is a growing confidence that a structural acceleration of growth is underway.

The acceleration of growth in the real sector has been reflected in the upward shift in the growth trajectory of non-food credit extended by commercial banks. The expansion in non-food credit at 29.8 per cent in the period 2003-07 is unprecedented in the history of the Indian economy. Bank credit growth has accommodated the buoyancy in consumption and investment demand, and has enabled greater credit penetration in the economy. Besides, the rapid growth of bank credit has also been accompanied by a wider dispersal across society than ever before. In particular, the growth of bank credit has favoured agriculture, retail lending, particularly housing, *i.e.,* the sectors involving households, which were hitherto largely priced out of the credit market.

It is noteworthy that high growth in the last four years has been associated with a moderation of inflation. The headline inflation rate, in terms of the wholesale price index, has declined from an average of 11.0 per cent during 1990-95 to 5.3 per cent during 1995-2000 and to 4.9 per cent during 2003-07. The trending down of inflation has been associated with a significant reduction in inflation volatility which is indicative of well-anchored inflation expectations, despite the visitations of adverse shocks, both domestic and external.

In this context, I quote from a recent book by Mr. Sadiq Ahmed of World Bank, titled 'India's Long Term Growth Experience', which has analysed the growth experience of India in two phases: from 1950 to 1980 (Phase I) and from 1980 till date (Phase II):

"On the whole, the ability to contain India's inflation rate at substantially below the world rate and the rate prevailing in non-oil-exporting developing countries during both phases is a testimony to the sound conduct of monetary policy. This is particularly encouraging because India faced many external shocks and associated adverse effects of imported inflation during phase II when it opened up the economy as opposed to the closed economy environment of phase I."

Yet another positive feature of developments in recent years is the marked improvement in the health of Government finances. The revenue deficit (RD), gross fiscal deficit (GFD) and the primary deficit (PD) moderated to 2.7 per cent, 4.1 per cent and 0.1 per cent, respectively, during 2003-07 from higher levels in the preceding period. There are also indications of the beginning of sustained buoyancy in the tax/GDP ratio, indicating the onset of intrinsic strengths in public finances. The improvement in the fisc is reflected in a turnaround in public sector dissaving from 2003-04 onwards. The improvement in the fiscal positions of both the Centre and the States, even after accounting for cyclical component in more recent years, has considerably alleviated the burden of fiscal dominance that monetary policy in India has had to traditionally contend with.

Perhaps, the most impressive gains in macroeconomic performance are reflected in India's external sector, which has shown dynamism and resilience in a fiercely competitive, globalised and somewhat uncertain international environment. Merchandise exports have been growing at an average rate of around 25 per cent during the last four years, with a steady increase in global market share, reflecting the competitiveness of the Indian industry. At the same time, exports of software and business services have expanded sizeably in recent years, indicative of the knowledge-based domestic services sectors and their competitive advantage. Greater integration into the global economy has enabled the Indian corporates to access high-quality imports from abroad and also to expand their overseas assets, dynamically.

International confidence in the performance of the Indian economy has built up strongly, as reflected in the recent upgrade of India to investment grade by all the leading international rating agencies. With the significant strengthening of the current and capital accounts, the foreign exchange reserves have more than doubled from US$ 76 billion at the end of March 2003 to US$ 200 billion at the end March 2007. The level of foreign exchange reserves, currently the sixth largest in the world, exceeds a full year's imports and is far in excess of the external debt.

The Financial Sector: A Retrospect

The thrust of the financial sector reforms has been on strengthening the financial institutions as well as developing various segments of the financial-market spectrum. The focus of reforms has also been on promoting the integration of financial markets so that financial intermediaries have the requisite flexibility in their operations. Indian banks' balance sheets have strengthened considerably, financial markets have deepened and widened and, with the introduction of the real time gross settlements (RTGS) system, the payment system has also become robust. In addition, more recently, the endeavour of the Reserve Bank has been on greater financial inclusion and reaching out to the common person.

The efficacy of financial sector reforms is reflected in the significant improvement in the asset quality of the banking sector. Currently, all scheduled commercial banks are compliant with the minimum capital adequacy ratio of 9.0 per cent. The overhang of gross non-performing assets of the scheduled commercial banks has declined from 8.80 per cent of advances in 2002-03 to 3.30 per cent in 2005-06. Operating expenses, as a ratio of total assets, have declined from 2.24 per cent in 2002-03 to 2.11 per cent in 2005-06. Thus, in terms of indicators of performance, given the background, the scheduled commercial banks have been able to deliver significantly in terms of stability, penetration and technological progress. In the process, the public sector banks' efficiency has also increased in an impressive manner and they are playing a very salutary role in financial inclusion. No doubt, there is scope and indeed a compelling need to increase penetration of banking services to all segments of the population and enhance both, efficiency and resilience in the system.

While the stability and efficiency imparted to the large commercial banking system is universally recognised, there are some other segments which warranted restructuring as well. The experience with the urban co-operative banks at the dawn of the decade led to the enforcement of strict prudential parameters, and currently the issue of multiple controls in this sector has been addressed. A vision document for their healthy growth has been formulated. Large-scale restructuring has commenced and is well under way. Similarly, issues relating to rural co-operative banking structures, regional rural banks, non-banking financial companies and development finance institutions have been considered actively and comprehensive measures have been planned and some of them are under implementation.

Short-term Outlook

On the basis of assumption of trend growth in agriculture, on account of initial forecast of long-period average rainfall; expected impulses for expansion emanating from the industrial and service sectors; and taking into account expected deceleration of global GDP growth by 50 basis points in 2007, the Reserve Bank in its Annual Policy Statement for 2007-08, placed, for policy purposes, the real GDP growth at around 8.5 per cent during 2007-08, assuming no further escalation in international crude prices and barring domestic or external shocks.

The inflation rates since the second half of the 1990s have been, by and large, benign despite sustained external capital inflows and continued surge in fuel prices. Reserve Bank's policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08. In view of the self-imposed medium-term ceiling on inflation having a salutary effect on inflation expectations and resultant reduction in socially tolerable rate of inflation, coupled with the evolving integration of India with the global economy, the Annual Policy Statement for 2007-08 contains a resolve to condition the policy and perceptions for inflation in the range of 4.0–4.5 per cent. This objective would be conducive for maintaining self-accelerating growth over the medium-term.

India's external sector has become resilient with the current account deficit being maintained at very modest levels and the recent trends are expected to continue to shape the outlook for the balance of payments. India's share of world trade has increased from 0.76 per cent in 2003-04 to above 1 per cent, reflecting the growing competitiveness of the economy. On the whole, the overall trade and current account deficits in 2007-08 are expected to be adequately financed by the expected net capital inflows in 2007-08.

Taking into account the high expansion of money supply worldwide, and given the monetary overhang of 2005-07, it is important to contain monetary expansion in 2007-08 at around 17.0-17.5 per cent, in consonance with the outlook on growth and inflation. The Annual Policy Statement for the year 2007-08 also placed aggregate deposits growth in 2007-08 at around Rs.4,900 billion and a graduated deceleration of non-food credit to 24.0-25.0 per cent in 2007-08 from the average of 29.8 per cent over 2004-07.

The fiscal position of the Government, both Central and States, is undergoing consolidation in terms of targeted reduction in fiscal deficit indicators. The improvement in the fiscal position of several States is particularly impressive, which augurs well for the sustained growth of the economy and lower inflation. The Union Budget for 2007-08 has placed the fiscal deficit at 3.3 per cent of GDP for the year 2007-08, as against 3.7 per cent in the previous year, in keeping with the spirit of the FRBM Act, 2003.

Way Forward: Challenges and Strengths

There are, undoubtedly, many challenges for the Indian economy, but it is useful to focus on more urgent of these.

First, the poor state of the physical infrastructure, both in terms of quantity and quality is considered by many to be the most critical hindrance for India's progress. The most important issues here are regulatory framework and overall investment climate, which are being addressed by the Government.

Second, the most complex and challenging issue relates to development of agriculture. While over 60 per cent of the workforce is dependent on agriculture, the sector accounts for barely 20 per cent of the GDP. Further, 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. The results of recent surveys on poverty in India, however, provide grounds for some optimism in regard to accelerated reduction in absolute poverty since the reform period.

Third, 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 care, in terms of minimum access to the poor, need to be filled.

There are reasons to believe that these challenges will be met, with some assurance of success, on account of many inherent strengths in the Indian society. I will narrate a few of these, relevant to this gathering.

First, India is a country of great diversities but with incredibly harmonious co-existence of various religions, languages and a unified culture. The familiarity with multiple languages in India prepares the people to adapt better to multi-lingual environment, making it easier for them to fit into international systems very smoothly. Also, a vast and growing pool of science and technology graduates and the millions who are familiar with English language are sources of strength for the emerging India.

Second, 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 the prerequisites such as skill-upgradation and sound governance are put in place to capitalise on it. More importantly, the demographic transition is likely to be stretched over a longer period since various states in India are at different stages of such transition - from Kerala to Uttar Pradesh.

Third, India has the advantage of having a thriving business culture. In terms of business environment, the impressive growth, coupled with market orientation of the economy, has been a bottom-up exercise, with a very broad-based and growing entrepreneurial class. These tendencies are perhaps reflective of a penchant for innovation amongst the growing entrepreneurial class in India, imbued with professionalism and seeking to be globally competitive. Friends, this area of business culture of India should be of great interest to the Chambers of Commerce in Bangladesh. Business-to-business contacts amongst the countries are, almost always, win-win situations since no business transaction will take place if it were not perceived to be so. Institutions like Reserve Bank are happy to enable such business relations thrive and prosper – be it for trade or investment.

Before concluding, let me share with you how a good business culture can be distinguished from not-so-good a business culture. When two persons commence a train or bus or plane journey as business partners and end up as strangers, it is not-so-good a culture. But when two persons commence a journey as strangers and end up as business partners, that is a good business culture. My appeal to you is that there should be intensive business-to-business interactions, dialogues and partnership between India and Bangladesh as long as they benefit businesses and peoples of both the countries. Public institutions like Reserve Bank of India assure a policy environment that is conducive to the growth of productive business culture that would help generating employment for the millions of youth in our countries.