Y V Reddy: India in emerging Asia

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Friends

I am honoured to be invited at the 12th International Conference on "The Future of Asia" organised by Nihon Keizai Shimbun, Inc. (NIKKEI). The choice of the topic for the Session by the organisers "India-The Rise of a New Economic Powerhouse" is indicative of the global confidence in India's economic performance and prospects for the future. However, as a central banker, I need to be conservative and modest in my approach to communication while retaining transparency and credibility. I would therefore, approach the subject by drawing from the overall theme of the Conference, namely, "The Future of Asia" and dwelling on India as part of the unfolding growth story of emerging Asia in the new millennium. In that context, some highlights of India's recent economic performance would be in order. I will also be presenting Reserve Bank of India's assessment on outlook and challenges for the Indian economy over the medium term. Of some interest to the audience may be a narration of some `not-easily-quantifiable' sources of strength for the Indian economy. I will conclude with a mention of evolving Indo-Japanese economic relations.

India, emerging Asia and the global economy

The emerging Asia[1] accounts for around 45 per cent of world population and around 11 per cent of world GDP, though in PPP terms the share of GDP is about 27 per cent. However, in recent years, given the strong growth, the emerging Asia has contributed almost one-half of the global growth in GDP. In emerging Asia, the annual growth in GDP of 8.4 per cent and 8.3 per cent during 2004 and 2005, respectively, was impressive considering that the growth in the world economy during the corresponding period was 5.3 per cent and 4.8 per cent, respectively. According to the IMF, this growth momentum in Emerging Asia is expected to continue in 2006 as well and real GDP in the region is projected to expand by 8.0 per cent, while the global growth is placed at 4.8 per cent for the year 2006.

Since the beginning of the new millennium, the strong performance of emerging Asia, combined with the continued dynamism of the US has helped to sustain the current worldwide expansion, offsetting sluggishness in Europe and also in Japan. Being the fastest growing economies of the world, over the past two years, China and India contributed 73 per cent to the Asian growth and 38 per cent to the world GDP growth (World Economic Outlook, IMF, September, 2005). If the recent recovery of economic activity in Japan gets strengthened, Japan is expected to be another engine of growth for the Asian as well as the global economy.

Some observers prefer to describe the emerging economies of Asia as re-emerging economies to clarify that shift of wealth to Asia that is taking place is not an unprecedented situation, looking back into economic history, of course, by about three centuries. As per an OECD publication, in 1700, India's share in world GDP was 24.4 per cent, while China's share was 22.3 per cent. Asia as a whole (including Japan) accounted for 61.7 per cent in 1700, which fell to 59.2 per cent in 1820, and to a low of 18.5 per cent in 1950, before climbing to 37.2 per cent by 1998 (Maddison Angus, "The World Economy: A Millennium Perspective", OECD, 2001). The re-emergence in the second half of the 20th century was led by resurgence of Japan, succeeded by the miracle of East Asian economies, followed by China's outstanding success, and currently strengthened by Indian economy's impressive performance in terms of both growth and stability. According to the data published in the World Development Indicators of the World Bank, India ranks fourth next only to the USA, China and Japan

[1] As per the definition adopted by the IMF in the Regional Economic Outlook on Asia and Pacific (May 2006), Emerging Asia refers to China, India, Hong Kong SAR, Korea, Singapore, Taiwan Province of China, Indonesia, Malaysia, the Philippines and Thailand.

in terms of size of the economies measured on the basis of Purchasing Power Parity (PPP). It is interesting that in terms of PPP, three out of the four largest economies of the world are in Asia.

In the recent years, the Asian economies are emerging as major trading partners of India. India's trade has grown faster with these countries than its overall trade growth. Emerging Asian economies accounted for a significant share of 22.4 per cent in India's total exports in 2004-05 (16.0 per cent in 1999-2000) and 20.1 per cent of total Indian imports (16.2 per cent in 1999-2000). In 2004-05, China has emerged as the second major export destination for India after the US and it has now become the largest source of imports for India, surpassing the US. Exports to China surged by 81 per cent in 2004-05, while imports from China increased by 67 per cent reflecting growing trade relations between the two countries. A similar trend was noticeable *vis-à-vis* the ASEAN-5 (Singapore, Thailand, Malaysia, Indonesia and the Philippines), but going forward there is vast scope for further expansion in trade with these countries. In a way, the increasing openness of the Indian economy to the external sector in recent years reflects its expanding economic relationships with rest of Asia. In recognition of the growing importance of Asian countries in India's foreign trade, the series of nominal and real effective exchange rate indices released by the Reserve Bank have been revised to include Chinese Renminbi and Hong Kong dollar in the weighting scheme. Japan being already included, the representation of Asian economies has increased to three out of the total of six countries.

Highlights of India's performance

In November 2005, Minister Mentor Lee Kuan Yew, the widely admired former Prime Minister of Singapore, said in the 37th Jawaharlal Memorial Lecture:

> "When I published the second volume of my memoirs in 2000, I wrote that India is a nation of unfulfilled greatness. Its potential has lain fallow under used".
>
> "I am happy to now revise my view – Nehru's view of India's place in the world and of India as a global player is within India's grasp."

While the change in India in the past five years seems dramatic, indeed, it is not discontinuous. First, India as a nation has been diligently working over half a century to realize the dreams at the time of its independence. Second, the domestic deregulation of 1980s and economic liberalisation of 1990s helped acceleration of growth. Third, perhaps, the world is appreciating India and its progress better now than before.

The three salient features in India's economic performance over the period 1980-2000, as mentioned by several analysts, have been a high growth of output per capita, surpassed only by China and East Asian countries; a very stable output per capita, surpassing that of even China and East Asia; and the growth is sourced by an increase in total factor productivity, thereby having positive implications of an enduring nature of the process, rather than being driven only by better returns on capital.

The Indian economy appears to be shifting to higher levels of growth trajectory in more recent years with the average annual growth of real GDP increasing to 6.3 per cent during 1992-93 to 2005-06 from 5.8 per cent in the 1980s. Again, lately, the economy is perhaps picking up an accelerated growth momentum, with an average GDP growth at around 8 per cent per annum during the last three years. It is equally notable that the inflation conditions have moderated to around 5 per cent, decelerating significantly from relatively higher levels in the earlier periods.

The strengthening of economic activity in the recent years has been supported by persistent increase in gross domestic investment rates from 23.0 per cent of GDP in 2001-02 to 30.1 per cent in 2004-05 coupled with more efficient use of capital. Gross domestic saving rate has also improved from 26.5 per cent to 29.1 per cent during the same period. The saving-investment balance in India is in a desirable range thereby contributing to global stability also.

Facilitated by reforms, financial markets have become freer and institutions more independent operationally. Monetary policy has gained more operational autonomy with discontinuation of automatic monetization of deficits since 1997 and Reserve Bank's withdrawal from primary gilt auctions from this financial year, combined with increasing reliance on indirect instruments. Money markets are orderly and stable with participants switching towards more collateralised segments and rates varying generally within a corridor set by the policy stance. Government securities markets are now deep and vibrant with varied instruments catering to varied investor perceptions. The foreign exchange market has acquired depth, while the capital markets have become mature in trading procedures, risk management as well as payment and settlement mechanism. India ranks as one of the three largest emerging markets in terms of stock-market capitalization. There are over 9000 listed companies, out of which about 100 companies have market values of more than US $1 billion each. Foreign investments span over more than 1,000 Indian companies which is an impressive record.

The banking sector has strengthened in recent years in terms of its conformance to sound prudential regulation and governance standards thereby minimising risks, strengthening disclosure and improving operational efficiency. Banks are migrating towards Basel II norms and are taking steps for containment of impaired loans. There have been marked improvements in the health of financial intermediaries and competition and efficiency have also improved appreciably, while simultaneously adding to stability and resilience to shocks.

Benefiting from a calibrated and sequenced strategy of liberalisation, India’s external sector has become more resilient. While the current account after remaining in surplus for three years up to 2003-04 turned into a moderate and sustainable deficit in 2004-05, there was a significant strengthening in the capital account resulting in continued accretion to the foreign exchange reserves. India’s foreign exchange reserves currently exceed its external debt, thereby reflecting improved solvency of the economy.

The exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way. The Reserve Bank intervenes in the foreign exchange market to contain volatility. Recent international research on viable exchange rate strategies in emerging markets has lent considerable support to the exchange rate policy followed by India.

The engagement of Indian firms with the world has acquired new dimensions. Apart from its leading edge in the software services, India is also becoming a major hub for manufacturing and export of manufactured products. The Indian information technology industry is becoming increasingly global through cross-border acquisitions, on-shore contract wins and organic growth in other low-cost locations. This has been complemented by global majors continuing to significantly improve their off-shore delivery capabilities in India. Indian firms are also acquiring manufacturing firms abroad to leverage comparative advantage of foreign locations, using synergies between the parent company and the company under acquisition and having production facilities near the major markets also.

Outlook and challenges: a central bank perspective

The Annual Policy Statement for the year 2006-07 released a month ago (April 18, 2006) provides the Reserve Bank of India's assessment of the outlook for the economy. The Policy Statement notes that a number of downside risks loom over the global economy that have implications for the medium-term prospects of countries like India for which the channels of global integration are getting stronger over time. The key global risks for emerging economies are potential escalation and volatility in international crude prices, a disorderly unwinding of the macroeconomic imbalances of the major economies and a hardening of international interest rates. Though characterised by significant downside risks, over the medium term, the prospects for the global economy are by and large positive.

For the Indian economy, the evolving economic and business environment exhibits a number of encouraging signs that suggest reinforcement of the robust economic growth demonstrated in recent years.

First, increase in the gross domestic saving rate to levels around 30 per cent, coupled with sustained absorption of external savings of about 2 per cent of GDP, would provide the potential for attainment of an accelerated growth trajectory.

Second, the micro structural reforms undertaken over the years have enabled continuing productivity gains in the real sector.

Third, the reform process involving widening and deepening of the financial sector, along with improved regulation and supervision, has also yielded encouraging results, as reflected in the productivity measures relevant for the sector.

Fourth, there is evidence of increasing business confidence as measured by various business expectation surveys and improvement in the investment climate. This is also corroborated by signs of enhanced levels of foreign direct investment.

Fifth, the most progressive and dynamic of the Indian companies are manifesting increasing levels of global presence through acquisitions and higher outward foreign direct investment. The attainment of domain knowledge through such activities, along with best practice business knowledge, and economies of scale in marketing may enhance the productivity growth of Indian business.

Finally, it is noteworthy that Indian business has managed to exhibit impressive growth performance in recent years in terms of most parameters despite the presence of significant constraints posed by infrastructure. It has also displayed resilience in terms of the ability to cope with adverse developments such as oil price increases.

Despite the positive factors for medium term outlook, there are some critical issues that need to be addressed for maintaining the current momentum of growth with stability.

First, the poor state of the physical infrastructure, both in terms of quantity and quality, has been rightly receiving the focussed attention of the business class and the policy-makers. There are some reasons to expect a satisfactory outcome, provided the improvement in regulatory framework is sustained. The current investments are demand-led and therefore, are likely to be completed with least gestation periods, coupled with a rapid payback on completion. 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.

Second, fiscal consolidation is taking place both at the Centre and States and there is greater consensus now on the broad directions. 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. However, the issues of power subsidies and ensuring quality in the delivery of services, especially with regard to education and health, do need to be addressed.

Third, and perhaps the most challenging issue relates to development of agriculture. While a majority of the workforce is dependent on agriculture, the GDP growth generated from agriculture is only marginally above the rate of growth of the population, in contrast to the strong growth rates in the non-agricultural sectors, which is not adequate to address rapid poverty reduction. To facilitate a more rapid growth in agriculture, legislative, institutional and attitudinal changes to supplement enhanced public and private investment may be needed. The Reserve Bank, for its part, is redoubling its efforts in revitalising the rural cooperative credit system, in strengthening Regional Rural Banks, in providing incentives to commercial banks for promoting investments in rural economy and in ensuring adequate and timely delivery of credit at appropriate price. In fact, we are studying legislation and implementation of non-institutional money lending, as it continues to be a significant source of credit for the farmers.

Despite the Indian economy being poised towards a higher growth path, perceptible improvement is yet to be made on reducing unemployment. The unemployment rate, based on periodical surveys increased in both rural and urban areas during the period 1994 to 2004. The sharper increase of unemployment rates in the rural areas reflects a slowdown in agriculture. A positive feature has, however, been a reduction in the poverty ratio from 36.0 per cent in 1993-94 to 26.1 per cent in 1999-2000. The Government of India has set a target to bring down the proportion of people living below the poverty line to 10 per cent by 2012, in line with the targets under the Millennium Development Goals (MDGs) adopted by the United Nations.

Not easily quantifiable strengths

A distinguishing characteristic of recent global assessment of future of India has been greater awareness and articulation of the strengths of India which are not easily quantifiable but are critical to the longer term prospects. I wish to draw your attention to some of the observations, in a summary form, without necessarily endorsing them.

In the social context, attention has generally been given to the advantage of Indians' proficiency in written and spoken English language. However, this inherent strength should be viewed in the backdrop of the linguistic diversity of India which encourages people to learn several languages other than the mother tongue. (There are twenty two national languages as per the Constitution of India.) The enhanced familiarity with multiple languages not only helps bring about integration in the country, but also prepares them to adapt better to multi-cultural situations. To illustrate, a recent report in Financial Times (by Peter March dated May 17, 2006) titled “Feast of a Movable Workforce” reads as follows:

> “In an anonymous office building in India, the J-Team is on a mission to strengthen links between India and Japan. H.B. Jayanthi heads the 60-strong group of Indian engineers who are working for Yojagawa, the Japanese industrial control systems market, in Bangalore. They have been trained to speak – and even to think – in Japanese so they can communicate effectively with colleagues in Japan while collaborating on product development”

In this regard, it is also useful to recognise the importance of empowerment of women. Let me illustrate with some relevant facts in my home State, Andhra Pradesh. There is a minimum allocation of one-third of admissions for women in medical colleges, but as of now, around half of the students are women. Of the 92,000 students admitted in engineering colleges this year in Andhra Pradesh, over 30,000 were women. Similarly in the political arena, women are very well represented. In the local bodies, there are about 250,000 elected officials ranging from a member of Gram Panchayats (village-level elected self-governments) to Mayors of Municipal Corporations and Chairpersons of Zilla Parishads (district level elected councils) and of these, over 85,000 are women. These developments, which are shared in different ways by other States, give a positive twist to the outlook for empowerment of women for the future.

Above all, the existence of a free press provides insurance against excesses and makes Governments at all levels more accountable than otherwise. In this regard, it is interesting to note that while 17 leading English newspapers have a combined circulation of 6.3 million and readership of 17.9 million, 54 leading vernacular newspapers in India have a circulation of 21.4 million and a readership of 197.2 million.

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. It is remarkable that political cycles have not hindered the progress of well-calibrated economic reforms. 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.”

In fact the political system should lend comfort to the global businesses in view of elements of long-term predictability. Ambassador Yasukuki Enoki, Japanese Ambassador to India is reported to have said:

> “For the next two decades, Indian society is predictable and democratic framework is predictable.”

As regards macro-economy, there is an increasing consensus that India has crossed the threshold of reform, leading the economy to become really market-oriented and price based economy. This orientation has helped the country emerging as the major service-outsourcing hub for the world. Moreover, acceleration in growth is expected to be sustained in view of the evolving pattern of domestic demand. For example, National Council of Applied Economic Research (NCAER) MISH data

> “clearly indicates that India is growing immensely wealthy. By the end of this decade, the structure of the country’s demographics will change from an inverted pyramid, signifying a small rich class and a very large low-income class, to a rudimentary diamond, where a significant part of the low-income class moves up to become part of the middle class.”

Further, there may be demographic bonus between 2010 and 2040 when India’s working population is still increasing while population in the rest of Asia may be levelling off or even declining. Moreover, public and private sector compete and co-exist in a dynamic balance which is imparting competitive strength to the economy.

Finally, 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. The capacity to innovate is considered high and costs of innovation are reportedly low in India. For example, engineering-intensive service-led manufacturing is sought to balance the advantages of standardised way of mass production of goods. Reportedly, there is an increasing emphasis on service approach to manufacturing with adaptation of techniques such as lean production to keep quality high and boost efficiency. 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.

Evolving Indo-Japanese economic relations

From global and our perspective, Japan, as a leading industrial economy, has made substantial contributions to the growth of world trade over the years. Japan has also played a key role in the integration of developing countries, especially emerging Asia, with the world economy in terms of trade and investment. The developing economies have been the major destinations and source of Japan's exports and imports, accounting for 58 per cent and 65.5 per cent of Japan's total exports and imports, respectively, in 2004. Within developing economies, the share of emerging Asia accounted for nearly 40 per cent of Japan's exports as well as imports.

India and Japan share a cultural bond dating back to many centuries. The two countries, in the recent times, have seen major improvement in the bilateral relations. The visit of the Japanese Prime Minister Mr. Koizumi to India in April, 2005 marked a high point in this bilateral relation. The visit highlighted the fact that the spiritual affinities, enduring cultural contacts and high degree of commonality of political, economic and strategic interests provide great strength to India and Japan as partners in a globalising world. An eight fold initiative to further strengthen this partnership was enunciated as an outcome of this visit. The intensity of high level contacts with Japan has continued since then and the Prime Ministers of the two countries have also met on the sidelines of the first East Asia Summit at Kuala Lumpur. The last one year has, therefore, seen intense engagement in our bilateral relations making Japan the focus of our policy in Asia.

India and Japan have many complementarities in the economic sphere also. Japan is a relatively labour scarce but capital abundant country whereas India has an abundance of an entire spectrum of human resources. Similarly, India has a world acknowledged prowess in the software sector and Japanese strength in the hardware sector is established for decades. India has a wealth of resources by way of raw-materials and minerals and Japan has the technology and capital to produce knowledge intensive manufactured goods. In short, if the two were to engage more intensively in terms of economic collaboration, the resulting synergies, the economies of scales and the complementarities could lead to great welfare gains for both the countries.

In recent times, Japanese Foreign Institutional Investors (FIIs) have started to evince an increasing interest in India and among the FIIs registered during the year 2004, a significant number belonged to Japan. Japan has also launched “India Investment Fund” to mobilize funds from Japanese investors to invest in Indian securities market. According to a survey on “Overseas Business Operations by Japanese Manufacturing Companies” (November 2004) carried out by JBIC, India emerged as the third most promising investment destination after China and Thailand as against 5th in the similar survey in 2003 and 11th in 2000.

Japan’s cooperation and participation in the accelerated economic development of India is deeply appreciated. Japanese assistance has been particularly helpful in the physical infrastructure sectors of power, urban transportation, urban water supply and sanitation, water management, seaports, tourism and also in the environment and forests sectors. Japan has been extending bilateral loans and grants assistance to India since 1958 and Japan is the largest bilateral official development assistance (ODA) partner of India.

In sum, growing closer links between Japan and India augur well for a bright future for Asia and a strong voice for Asia in the global economy.

Concluding remarks

Let me conclude by answering three important questions relating to public policy in India. First, what is the dominant objective of public policy? In Prime Minister Manmohan Singh’s words:

> “The first and foremost priority is to finish the unfinished task which the founding fathers of our republic set out for us at the time of Independence: to get rid of chronic poverty, ignorance, and disease, which have afflicted millions and millions of our people. Great progress has been made. Particularly in the last 20 years, the Indian economy has done quite well. We need to underpin that growth by strong performance of our agriculture, strong performance of our physical and our social infrastructure. These are our key priorities.”

Second, what are the means by which the objective can be achieved? Put succinctly, they encompass modernising the country's infrastructure - physical, social and governance; creating jobs and, attracting foreign investment for the purpose.

Third, in this context, what is the appropriate message to global managers as they think about India? Prime Minister Manmohan Singh's response to this question was:

> "India's future lies in being an open society, an open polity, a functioning democracy respecting all fundamental human freedoms, accepting the rule of law and, at the same time, to emerge as a successful, internationally competitive economy."

Thank you.