

## Y V Reddy: The rise of Asia – implications for the global economy

Memorial lecture by Dr Y V Reddy, Governor of the Reserve Bank of India, on the occasion of the 40th anniversary celebrations of the Bank of Mauritius, Mauritius, 3 December 2007.

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The Honourable Vice-President of Mauritius, Honourable Ministers, Respected Governor Rundheersing Bheenick, Mr. Googoolye, Dr. Khadaroo, Directors of the Board of the Bank of Mauritius and distinguished friends.

It is a great honour and privilege to be invited to deliver a Memorial Lecture on the occasion of the 40th Anniversary Celebrations of the Bank of Mauritius. The invitation is yet another demonstration of not only the close ties between India and Mauritius but also between the two central banks, which have a mutually beneficial and very special relationship. I am personally grateful to Governor Bheenick for giving me the opportunity to be here with you.

The Honourable Prime Minister, Dr. Navinchandra Ramgoolam, in his address on August 24, 2007, to commemorate the 40th anniversary celebrations of the Bank of Mauritius, paid rich tributes to the Bank. He specifically referred to the effort and dedication that have gone into making the Bank “*a successful and well respected institution*”. I would amplify that the Bank has become a globally well respected institution and we, in the Reserve Bank, have got great trust and confidence in our counterpart in Mauritius.

The Bank for International Settlements, Basel, Switzerland, (BIS) in its Review 99/2007, carried Governor Bheenick’s address on the same occasion on August 24, 2007 which is titled “Escaping the fate of Dodo”. It is a brilliant exposition of not only the evolution and the successful adaptation of the Bank of Mauritius to the changing circumstances, but also on the theory and practice of central banking. On the tasks ahead, Governor Bheenick mentioned that “*this Central Bank needs to achieve this transition from being the Bank of Mauritius to being the Bank for Mauritian; the Bank of the people. We must make the sound financial choices for every family, the easy choices*”. We, in the Reserve Bank of India, have recently set ourselves similar mandate. Let me formally congratulate the Bank of Mauritius on its successful journey into the 41st year and wish it all the best in its pursuit of the goals of growth, stability and, above all, service to common persons.

The theme for today’s lecture is “The Rise of Asia – Implications for the Global Economy”. I want to approach the subject with considerable humility. My first trip to Mauritius was in 1997, in connection with the Commonwealth Finance Ministers’ Conference. From here, I was scheduled to proceed to Hong Kong for attending the IMF / World Bank Annual Conference. However, I chose to cancel my trip to Hong Kong and, instead, returned to Mumbai since the financial markets in India indicated some sort of unease. It was about that time that the full blown Asian Crisis erupted. For months and years thereafter, we deliberated on the unfortunate developments in the Asian economies and the consequent difficulties, as well as the need for reforms. On my second trip to Mauritius, after ten years, now we are not merely celebrating the success of the Asian economies but also contemplating on how they may contribute to the global growth and stability. It has been a remarkable turnaround for the Asian region, and no one could have predicted this outcome, ten, or even five, years ago.

Second, could anyone have anticipated turbulence in financial markets that would emanate from the advanced economies like the United States and more particularly from a global financial centre?

Third, how many could envisage a situation where the largest financial intermediaries, especially global banks, which are highly rated for their risk management capabilities, would

suddenly lose full confidence in the liquidity position of each other and thus become reluctant to deal with each other? Consequently, some central banks have, perhaps justifiably, pumped in huge liquidity into the system on extra-ordinary liberal terms.

Fourth, in a related event, in a leading global financial centre, the government had to take initiatives to support a bank when there was a run on the bank – an approach that was seldom on the drawing boards of governments, in recent years.

In brief, the need for humility arises because recent history has shown that we do not know enough to predict economic outlook for nations, or the global economy, with any reasonable degree of certainty. Moreover, the current global economic environment is particularly uncertain, making such predictive exercises very tentative.

In this background, let me present a few perceptions about the Asian economies in the global context. At the outset, we should recognise that Asia is a large region with several countries and economies that are of varying size and nature, which are at different stages of integration with the global economy and also with each other. Hence, what is attempted here is a set of very broad generalisations.

The growing importance of Asia in the global economy is well-documented and hence a brief recall should suffice. Asia can boast of three of the ten largest economies in the world – these are Japan, China and India. In 1980, Asia accounted for 19 per cent of the global Gross Domestic Product (GDP) in Purchasing Power Parity (PPP) terms. Today, Asia accounts for over 36 per cent and by the year 2020, it is expected to reach over 45 per cent. Currently, Asia contributes close to 50 per cent of world growth in PPP terms. Asia's share in the global trade is increasing rapidly and trade within Asia is also increasing in an impressive fashion. The Asian economies are more open to each other now, than ever before.

However, while the size of the national GDP, in comparison with those of others, is very important, the levels of per capita GDP in each nation, in PPP terms, is also somewhat relevant. As per Maddison's projections, the per capita GDP of China will be about one-fourth of that of the US in the year 2030, though the GDP of China is expected to surpass that of the US within the next twenty five years. This broadly reflects the position of most of the Asian economies vis-à-vis the advanced economies. In brief, therefore, there is merit in combining justifiable enthusiasm for a rising Asia with a dose of humility, which is warranted by the long journey ahead.

The impressive growth in Asia has benefited the global economy in several ways, though some issues have emerged. First, by producing highly competitive goods and services, Asia has helped enlarge the range of goods available and enhance their quality. As a consequence, world over, billions of consumers, as a group, have benefited from the growth of Asia. This process helped central bankers, globally, in containing inflation and inflationary expectations. In view of the vast reserves of labour force that will be available in Asia for several decades to come, and the strides made in the field of technology, many expect the process to continue, perhaps not necessarily with the same intensity.

Second, many commodity producing countries, especially in Africa and Latin America, have benefited through better terms of trade and increased export earnings, as well as increased economic activity, by catering to the rising demand from Asia. Thus, Asia supplemented the US in providing impetus for global growth. As Asia is expected to continue the growth momentum, the positive impact is expected to persist.

Third, rapid growth of large economies in Asia may continue to generate significant opportunities for expanding the markets for other economies, especially the neighbouring economies, and these could certainly include tourism and financial products also.

Fourth, a few advanced economies tended to experience some discomfort in the rise of Asia since competitive forces put pressure on wages of some categories of workers, though, as consumers, the general populace benefited from the process.

Fifth, there are additions to demand for energy due to rapidly growing Asia and, according to some, thus impacting oil prices. In terms of the existing levels of energy consumption, Asia is still a minor player in the overall energy market. Further, many attribute the rising oil prices to financialisation of commodities and speculation. No doubt, over the medium to long term, there is scope for improving efficiency in the use of energy in Asia. The energy economy of the world and the rise of Asia may continue to interact in a dynamic setting in future also.

Sixth, the economic growth in Asia has resulted in an unprecedented number, in millions, of people moving out of poverty levels every year thus generating demand for food items, including cereals and milk. The structural increase in demand for food on account of Asia may continue for several years. While demand for food is relatively inelastic, the supply side is often influenced by several factors, including political economy considerations. The problem is accentuated by the uncertainties in the global climatic conditions and increasing financialisation of trade in these commodities.

Finally, the monetary authorities are facing very complex challenges, since traditionally oil prices were treated as “shocks” and food prices are also treated as some sort of a “shock”. It is now realised by the monetary authorities, in advanced economies also, that food prices have significant impact on inflation-expectations, which are vital for the conduct of monetary policy. In developing economies, the problem is more acute since the weight for food prices in price indices is large.

Way forward, all of us recognise the growing importance of Asia in an inter-dependant world. Hence, Asia needs to be conscious of the challenges to public policy and the international community would also gain by being supportive of policies that benefit Asia and the global economy over the medium term to longer term. Such collaborative and mutually reinforcing policies are critical for growth and stability in all regions.

Let me recount a few important challenges in Asia. First, two-thirds of the world’s desperately poor live in Asia. According to the Asian Development Bank (ADB), 620 million people within the region are still living on less than one US dollar per day and if we raise the limit to two US dollars per day, the number would be more than a billion. Hence, a policy of inclusive growth becomes critical and, indeed, essential.

Second, the share of Asia in billionaires and high networth individuals (HNIs), relative to other regions, is growing disproportionately, which could flag concerns regarding maintenance of social and political stability. The consequences of growing regional inequalities are being felt in several Asian economies. There is evidence of several policy initiatives in this regard also.

Third, the urban population in Asia may double by the year 2030 relative to the year 2000. By 2030, Asia will have about 2.7 billion urban people, while all other regions in the world will have a combined urban population of about 2.3 billion. This will result in large demands on urban infrastructure. At the same time, due to globalisation and growth experiences, the urban residents will be more demanding in regard to quality of urban infrastructure and services. Hence, public-private participation, cutting across national boundaries, may become significant.

Fourth, the demographic trends in Asia over the next 50 years are expected to be reflective of the past 50 years for developed countries, with significant divergence among the various Asian economies. The expected increase in old age dependency during 2000 to 2025, and further on to 2050, may increase fiscal pressures. However, countries such as India and Indonesia are expected to reap benefits of demographic dividend over a longer period

ahead, than the other Asian economies, perhaps for another 25 years. Reaping benefits of demographic dividend is dependent upon enhancing quality of health conditions, imparting better skills and improving public infrastructure so as to take advantage of globalisation. In the absence of appropriate public-policy initiatives, what could be a demographic dividend could turn out to be a demographic problem.

Finally, the global community has to address the issue of adequacy of voice and representation to a rising Asia in the current international financial architecture. In other words, governance structures and arrangements need to reflect the new realities of a rapidly growing Asia, in the interests of all stake holders.

An issue of contemporary importance is the possible interaction between recent events in global financial markets and Asia. As of now, all relevant aspects of financial markets and institutions are yet to be fully transparent. There is a feeling that full normalcy is yet to be restored in the global financial markets. The impact on the real economy in the USA is yet to be fully felt and a possible slow down in that economy is not ruled out. While neither financial contagion nor slow down in the US economy is ruled out, the global consensus, as of now, is that global growth will be robust as anticipated, but with heightened uncertainties. At this stage, therefore, we can make only a few very broad observations on the likely impact of global financial conditions on Asia.

The economic reforms in the real sector have improved the overall productivity and resilience in Asia. The macro economic conditions in Asia, as a whole, are significantly stronger and conducive to overall stability relative to the past. The financial systems in most countries, both markets and institutions, are far more efficient and resilient than before. The external sector has been strengthened and considerable reserves provide cushions to withstand financial contagion. In fact, it is felt by many, that Asia's reserves can help smoothen the process of unwinding of global imbalances that appears to be underway through, what has been described as "*falling with a parachute*" scenario. Overall, the economies in Asia seem to be reasonably equipped to withstand, to some extent, heightened volatilities in most of the financial markets.

The possible impact of adverse developments, if they happen, on the real sector is, however, less clear. While some hold that any slow down in the US will impact Asia adversely, since Asia's exports to the US are large, others hold that some "de-coupling" has occurred in view of the growing intra-Asia regional trade. It is also argued that intra-regional trade in Asia is linked to exports to the US. A more plausible scenario would be that slow down in the US, if it takes place, would, to some extent, dampen the growth in Asian economies, but to the extent there has been some elements of decoupling, which may be country specific also, the impact may be moderated. In other words, it will be unrealistic to hold that Asia can substitute for the US as the major engine of global growth at this stage. Hence, heightened vigilance among Asian central banks appears to be common.

We, in India, are monitoring (a) the process of restoration of full normalcy in global financial markets; (b) the evolving financial contagion; and (c) the possible spill-over to the real sector after accounting for the possible extent of "decoupling". The major reason for extraordinary vigilance by the Reserve Bank of India, at this juncture, is what I would describe as simultaneous volatilities in several globally significant markets, namely, money, credit and currency markets; asset prices; and commodity prices, especially oil and food items. The current phenomenon of simultaneous volatilities should be viewed in the context of possible repositioning of the world's dominant reserve currency, involving significant wealth, income and terms of trade effects.

Ladies and gentlemen, let me now turn to the Indian economy in greater detail. Before independence, during the first five decades of the 20th century (1900-01 to 1946-47), the annual average growth performance of the Indian economy was very low, averaging 0.9 per

cent per annum. Since the beginning of the planned development process, in the early 1950s, the GDP growth displayed a self-accelerating tendency reaching a level of around 6.0 per cent in the 1990s. Two exceptions during this phase were the dipping of the growth rate in the 1970s to 2.9 per cent and during the crisis year of 1991-92<sup>1</sup> when the growth was as low as 1.4 per cent.

In the new millennium, the GDP growth rate has accelerated further averaging 6.9 per cent during the seven-year period 2000-01 to 2006-07, while the growth rate in the last four years (2003-04 to 2006-07) averaged 8.6 per cent. In 2005-06 and 2006-07, it has grown still higher at 9.0 per cent and 9.4 per cent, respectively. During this phase too, in one year during 2002-03, the growth rate dipped to 3.8 per cent due to drought conditions in several parts of the country leading to significant fall in agricultural production.

The strengthening of economic activity in the recent years has been supported by persistent increase in gross domestic investment rates from 24.3 per cent of GDP in 2000-01 to 33.8 per cent in 2005-06 and domestic saving rate from 23.7 per cent in 2000-01 to 32.4 per cent during 2005-06. It is important to note that over 90 per cent of investment during this period was financed by domestic savings.

In tandem with acceleration in the rate of investment in the economy, there has been evidence of a pickup in productivity and efficiency of capital use. Some of the recent studies relating to India have indicated an increase in total factor productivity (TFP) in recent years.

While growth rate has picked up in the new millennium, the inflation rate has moderated to still lower levels ensuring price stability. Since 2000-01, the annual inflation rate, as measured by Wholesale Price Index, has averaged below 5 per cent despite the recent oil price shock.

Fiscal management in the country has significantly improved with the combined fiscal deficit of Centre and States declining from 9.5 per cent of GDP in 2000-01 to 6.4 per cent in 2006-07. However, combined public debt of the Centre and the States, as proportion of GDP, remains high at over 70 per cent.

India's external sector has become resilient with the current account deficit being maintained at very modest levels after a few years of marginal surplus during 2001-02 to 2003-04. The value of both exports and imports, in US dollar terms, has tripled by 2006-07 relative to 2000-01, and the current account deficit remained modest at 1.1 per cent of GDP, or below, for four out of the seven years, while there was a surplus in the remaining years. On account of strong capital flows, there have been accretions to foreign exchange reserves, which, at US \$ 271.2 billion as on November 16, 2007 are currently higher than the external debt (US\$ 165.4 billion at end-June 2007).

For monetary policy purposes, the Reserve Bank, in its Annual Policy Statement of April 2007, placed the real GDP growth for the current year, 2007-08, at around 8.5 per cent, assuming no further escalation in international crude prices and barring domestic or external shocks.

The policy preference for the period ahead is strongly in favour of price stability and well-anchored inflation expectations with the endeavour being to contain inflation close to 5.0 per cent in 2007-08. In recognition of India's evolving integration with the global economy and societal preferences in this regard, the resolve, going forward, would be to condition expectations in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent

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<sup>1</sup> In India, the fiscal year is from April 1 to March 31.

becomes a medium-term objective, consistent with India's broader integration into the global economy.

The Indian economy is confronted with some major challenges in the medium term. First, though about 60 per cent of the Indian population is still dependent on agriculture, its share in the GDP has been declining steadily over the years and now accounts for less than 20 per cent of the GDP. Enhanced growth of the agricultural sector is, therefore, vital for ensuring food security, poverty alleviation, price stability, overall inclusive growth and sustainability of growth of the economy. Second, absence of modern infrastructure and shortage of skilled manpower are the most critical barriers to the growth. It is, hence, imperative to augment the existing infrastructure facilities, particularly roads, ports and power, to provide the enabling environment for industry to prosper. Third, in order to reap the benefits of the demographic dividend, substantial expansion and reforms in the education sector would be needed on an urgent basis. Fourth, reprioritisation of expenditures towards social sectors along with higher capital outlays is required to promote fiscal discipline without restricting operational efficiency of the Government. Fiscal empowerment would allow higher capital outlays and boost infrastructure and social sector spending with beneficial impact on domestic productivity, growth and employment. It is, thus, necessary to emphasise the criticality of quality of fiscal adjustment. Finally, to meet the growing credit demand and sustain high economic growth, banks need to widen their deposit base. Banks need to bring more and more financially excluded people within their fold, which would help the low-income households and strengthen financial deepening.

I have already alluded to some of the quantitative positive aspects of the Indian economy, such as savings-investment balances, and price stability, just a while ago. Now, I will narrate some of the prominent non-quantifiable strengths which are expected to help in facing the challenges mentioned above. First, it is endowed with a vast pool of science and technology graduates and millions of people who are familiar with English language. Second, familiarity with multiple languages makes adaptation better to multi-cultural situations, making it easier for the Indian manpower to fit into international systems smoothly. Third, being the largest democracy of the world and the existence of a free press provide some insurance against excesses and make Governments more accountable than otherwise. Fourth, the empowerment of women in the recent years has helped them to defend their rights and helped to gain greater self-esteem and control over their own personal lives and social relationships. Fifth, despite the coalition cabinets and periodic elections, the political climate is characterized by political system stability. Sixth, considerable "demographic dividend" can be realised by putting in place prerequisites such as skill-up-gradation and sound governance. Finally, in terms of business environment, a fast emerging very broad-based growing entrepreneurial class, with a penchant for innovation and imbued with professionalism, is seeking to become globally competitive.

However, to ensure continued successful performance of the economy, it is generally recognised that all stakeholders need to strengthen State capacity and enable it to perform its core functions more effectively and equitably.

Referring to the long-term economic outlook for emerging market economies, in general, and for India, in particular, Mr. Jean-Claude Trichet, President, European Central Bank, said in the Tenth L K Jha Memorial Lecture on November 26, 2007 that *"..it suffices to recall how significant India's weight in the world economy was two millennia ago, when the Middle Kingdoms were ruling in India and the Roman empire was ruling in Europe and North Africa. At that time, India was by far the world's largest economic power, accounting alone for about a third of world output. Moreover, at par with China, it subsequently remained the largest economy in the world for several centuries, until the eve of the industrial revolution. Seen from this long-run perspective, the rapidly growing importance of India in today's world economy seems to be a return to normality."*

## **Concluding remarks**

Governor Bheenick made a brilliant exposition of achievements, policies and challenges for Mauritius in a presentation at the BIS/African Governors' Conference in Cape Town a few weeks ago. I am, therefore, convinced of a bright future for Mauritians and the Bank of Mauritius, in particular, under his leadership. There are some telling aspects of the Mauritian economy and public policy of Mauritius that appear to be worthy of note by the other countries, especially economies in Asia that we are speaking about, including of course, India. I will allude to some of these aspects now, which we in Asia will be well advised to take note of and imbibe.

The November 2007 issue of the journal "African Business" carries an Index on African Governance 2007 and, as per the final score, Mauritius occupies the number one position in Africa. Mauritius is also ranked first in the latest global African Competitiveness Index of the World Bank and the International Finance Corporation. My personal observations show that many of us, in Asia, could study and learn from the public policies in Mauritius relating to high coverage and quality of primary education, efficient delivery of health services and protection of environment. Yes, we have a lot to learn from each other and there are many areas in which we can cooperate. The two central banks will, I am sure, strengthen the traditional ties. We will carry forward a continuous dialogue to strengthen cooperation between the Bank of Mauritius and the Reserve Bank of India.

As a reciprocal gesture, let me extend an open and standing invitation to Governor Bheenick to visit India soon and, in addition, participate in the celebrations of 75th Anniversary of the Reserve Bank, which is due soon in a couple of years from now.

Thank you all, ladies and gentlemen.