Y V Reddy: Indian economy – prospects for growth with stability

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Institute of South Asian Studies, Singapore, 20 May 2008.

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Mr. Gopinath Pillai, Chairman, Institute of South Asian Studies (ISAS); Mr. Heng Swee Keat, Managing Director, Monetary Authority of Singapore (MAS); Dr. Jaishankar, Honorable High Commissioner; and distinguished friends.

I deeply appreciate the invitation from the ISAS to address this august gathering of policy makers, eminent academics, and market participants of Singapore. Singapore is an important financial center of the world and a very special partner for India, in the Asian region, in terms of economic co-operation. I am grateful to my counterpart, Mr. Heng Swee Keat, for encouraging me to accept the invitation. We meet often in connection with several international gatherings and exchange notes, concerns and comforts. We had the privilege of receiving him in the Reserve Bank of India (RBI) in August 2007. He gave us an excellent account of the functioning of MAS and ASEAN.

As a first step towards close collaboration between the RBI and the MAS, we have conveyed in March 2008, our approval to DBS Bank, Singapore to open eight branches. On the same day we also conveyed our approval to United Overseas Bank Ltd. to open its maiden branch in Mumbai. These approvals are significant in view of the freedom that accrues to the branches to undertake a full range of banking and related activities almost on par with full-fledged domestic banks and also the fact that our W.T.O. obligations require us to approve twelve foreign bank branches in a year. We, in the RBI, deeply appreciate the consideration and understanding displayed by the MAS in giving new branch licenses for Indian banks and in particular for the approval to SBI for full bank license with QFB privileges with effect from April 25, 2008. This visit of mine is intended to further re-inforce a productive and mutually beneficial relationship between the two monetary authorities and also the two economies, encompassing public and private sectors. I had called on Mr. Heng Swee Keat in his office in this regard, earlier in the day. I will be shortly making a courtesy call on Mr. Tharman Shanmugaratnam, the Honorable Minister for Finance, since, among other things, I was a witness to his erudition and eloquence in several fora – including the G30 conclaves.

In my brief address today, I will make a few observations on India's prospects for growth with stability in both short and medium terms, by highlighting a few important aspects. During the discussion that follows, we could interact on the major focus, as well as specifics, that is of interest to the gathering today.

Short-term prospects

For policy purposes, real GDP growth has been estimated to be in the range of 8 to 8.5% for the year 2008-2009 (year ending March 2009). There are several reasons why this expectation is realistic. Over the last five years, the Indian economy has expanded on an average at 8.7 percent per annum. In fact, GDP growth was 9.6 percent in 2006-2007 and has moderated to an estimated 8.7 percent in 2007-2008. This moderation is partly attributable to preemptive monetary policy actions that sought to dampen excessive demand pressures, while continuing with enabling environment to enhance supply-side responses in terms of investments. While there is a growing importance of global factors, India's growth is mainly driven by domestic demand and supply factors. Gross Domestic Savings continue to be around 35% of GDP and available evidence points to continued increases in productivity. The realisation of the expected growth in the current year assumes normal monsoons and a slow-down in global growth by not more than what is currently assessed.

Monetary policy in India accords appropriate priority for price stability in recognition of its significance for the large segment of the poor who have no hedge. Further, the policy recognizes that high growth benefits the poor with a lag, while inflation adversely affects them instantly. Hence the current high-level of inflation is totally unacceptable, especially in terms of impact on inflation expectations. The monetary policy, however, reckons the complexities of the current bout of inflation. Accordingly, the recent emphasis is on liquidity management with option to take recourse to all other measures, as necessary, so that demand pressures are contained consistent with supply-side responses from the markets and from the central and the state Governments.

The annual policy plans for a reduced rate of money supply in the range of 16.5 to 17% in 2008-2009, while correspondingly placing growth of non-food credit at around 20%. As per indications, the currently elevated level of the wholesale price index may start moderating noticeably as monetary, fiscal, and administrative measures impact the economy, while other seasonal as well as global factors turn favorable. As mentioned in the annual policy, the policy endeavor is to bring headline inflation to around 5.5% in 2008-09 with a preference for bringing it as close to 5.0 per cent as soon as possible, recognising the evolving complexities in globally transmitted inflation. The resolve, going forward, would continue to be to condition policy and perceptions for inflation in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent becomes a medium-term objective consistent with India's broader integration into the global economy and with the goal of maintaining self-accelerating growth over the medium-term. In the event of new adversities emanating in the domestic and global economy at any point of time, RBI is in readiness to respond swiftly and appropriately.

It is noteworthy that the domestic financial markets have not been seriously affected by the financial turbulence overseas, except for some increased volatility in the equity market, which is relatively more open. The available indications point to continued stability in the Government securities market; the forex market in view of a continued strong and sustainable external sector; and the money market, duly supported by focus on liquidity management. While the trade account may be impacted by elevated oil prices, the current account deficit is expected to continue to be modest, thanks to strong invisibles, and could be comfortably met by the anticipated net capital flows.

As regards financial institutions, there are indications of continued improvements in efficiency and enhancement of resilience. India has a bank dominated financial sector, and every scheduled commercial bank in the country has higher capital adequacy than the minimum prescribed ratio of nine percent. In fact, provisioning and risk-weight requirements have been tightened in a timely manner by the RBI to supplement monetary measures, in order to moderate early signs of overheating. The RBI continues to accord a high priority to financial stability while emphasizing the interest of depositors, service to the common person, financial inclusion, and an enabling environment for growth through efficiency gains.

In brief, the short-term prospects for an impressive growth with a reasonable assurance of stability continues to be bright, though somewhat subdued by global uncertainties. The fundamentals of the Indian economy do not warrant exaggerated bearishness that is being witnessed in some quarters now, just as exaggerated bullishness was not justified during some of the earlier periods. The policy will continue to address the prevalent issues of containing the inflation expectations and sustaining the growth prospects.

Medium-term prospects

For a large and diverse economy with a low per capita income that is undergoing structural transformation in a highly uncertain global environment, challenges for public policy are manifold. I would focus on a few, which we in the RBI consider to be crucial for enhancing medium term prospects for equitable growth.

First, while over 60 per cent of the workforce is dependent on agriculture, the sector accounts for less than 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. Volatility in agricultural production has not only implications for overall growth but also, as the recent experience has amply demonstrated, for maintaining low and stable inflation. Enhanced growth of the agricultural sector is vital for ensuring food security, poverty alleviation, price stability, overall inclusive growth and sustainability of growth of the overall economy. Recently, our Honourable Prime Minister announced a major scheme to double the growth rate of agriculture to 4.0 per cent over the 11th Plan period. A time-bound Food Security Mission was also announced to counter rising prices of food products and to ensure visible changes in their availability over three years.

Second, the inadequate availability of modern infrastructure and shortage of skilled manpower are the most critical barriers to the growth of the manufacturing sector. It is essential to augment the existing infrastructure facilities, particularly roads, ports and power, to provide the enabling environment for industry to prosper. The most important issues here are regulatory framework and overall investment climate, which are being addressed by the Government. One other concern has been the cost recovery, which is expected to improve with enlightened public-private partnership. India has the design, construction, technological, organisational and financial capabilities domestically to bring about efficient and prompt improvements in physical infrastructure to meet the emerging demand pressures.

Third, a salient feature of the fiscal consolidation process in recent years, even after accounting for cyclical elements, has been significant reduction in the key deficit indicators. Our studies on State finances in the RBI give grounds for optimism in regard to their fiscal health. In fact, some state governments are buying back their debt from the market and a few others are reducing their planned market borrowings. We recognize two important areas that, if addressed, would result in fiscal empowerment both at the centre and the states. One is reduction in subsidies, by eliminating those which are inappropriate and not directly targeted to the poor, and the other is withdrawal of most of the tax exemptions, which are distortionary. The delivery of essential public services such as education and health to a large section of our population is a major challenge.

Fourth, the unemployment rate based on periodical surveys increased both in the rural and urban areas over the last fifteen years, with sharper increase in the rural areas, reflecting a slowdown in agriculture. A positive feature has been a significant reduction in the poverty ratio, but the number of poor is still unconscionably high. Naturally, the overarching priority for public policy is creating employment and reducing poverty. Some of the recently launched employment guarantee schemes seek to address some of these issues and RBI plays a supporting role through a programme of financial inclusion in the banking sector.

Finally, there is a growing recognition in India that governance reforms are critical to strengthen state capacity and enable it to perform its core functions. The task of improving the institutions of economic governance comprise, among others, many organizations and actions essential for efficient functioning of markets. It is recognized that good governance can co-exist only when the public sector functions fairly and efficiently, which is achievable by improving it and not by undermining it. The business community has, therefore, a vital stake in improving and empowering public institutions.

There are grounds for optimism in regard to growth momentum and stability over the medium-term, even after accounting for the above-mentioned challenges. The persistent increase in gross domestic savings and total factor productivity indicate increasing level of potential output. There are discernible elements of self-sustaining and accelerating competitive strengths, as evident from increasing global presence of Indian corporates and interest of global companies in India. The savings and investments balance as well as the external sector reflect the strength and the resilience in the Indian economy. The micro structural reforms undertaken in the real economy are bearing fruits in some states resulting in double digit annual growth in their domestic product. Other states are trying to follow the example of these growth pioneers.

There are certain “not easily quantifiable strengths” which the Indian economy possesses. A vast pool of science and technology graduates and the millions of people who are familiar with the English language are sources of strength. The familiarity with multiple languages in India prepares the people to adapt better to multi-cultural situations, making it easier for them to fit into international systems smoothly. 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 in several States. 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 pre-requisites such as skill-upgradation and sound governance to realize it are put in place. 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 among already large and growing entrepreneurial class in India, imbued with professionalism and seeking to be globally competitive.

In brief, the medium term challenges are many, but all indications point to a sense of overall optimism for some acceleration in the already high rate of growth, with reasonable stability. Perhaps we should track not only the addition to the number of billionaires in India but also the depletion in the number of millions of poor and unemployed. For some, Indian economic progress signifies the beginnings of a major economic powerhouse in the world. But for many of us, the optimism over the medium-term is only the beginning of an arduous journey to ensure basic nutrition, clean water, safer sanitation, minimal housing, personal security and individual dignity for millions in India. The prospects for growth and stability in India are great, but greater are the challenges in fulfilling the very basic objectives of public policy.

Conclusion

Let me conclude by choosing some quotes from Minister Mentor, Lee Kuan Yew’s Jawaharlal Nehru Memorial Lecture on November 21, 2005, in New Delhi.

Referring to the unforgettable opening of Nehru’s broadcast on the eve of independence, Minister Mentor Lee Kuan Yew said, “The destiny Nehru envisaged was of a modern, industrialized, democratic, and secular India that would take its place in the larger historic flows of the second half of the Twentieth Century.”

“Nehru’s view of India’s place in the World and of India as a global player is within India’s grasp.”

“At stake is the future of one billion Indians. India must make up for much time lost.”

“The time has come for India’s next tryst with destiny.”

Thank you.