K C Chakrabarty: India's economic transformation – a snapshot

Inaugural address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the Antique India Markets Conference 2009, Mumbai, 7 September 2009.

The assistance provided by Mr. Rajan Goyal and Mr. Sujit K Arvind in preparation of the address is gratefully acknowledged.

* * *

Mr. K.V. Kamath, Chairman, ICICI Bank; Mr. Gagan Chaturvedi, Director, Antique Finance Limited; Distinguished participants from different parts of the World, invited guests, Ladies and Gentlemen:

It is a great pleasure for me to be here in such august company and distinguished group of people. I would like to thank the organisers for inviting me to share my thoughts on a topic which has great relevance for sustained growth of Indian economy. I would be sharing my views with all of you during this session on, "India's Economic Transformation" and its changing contours over the years. Structural reforms, during last two decades, have unambiguously altered the economic landscape of the country. However, there are certain questions/ concerns that have always been a source of discomfort and have acquired a new relevance as economy moved to a higher growth trajectory in recent years. For instance, how inclusive our growth process is? Are we moving towards affording a decent standard of life to people at large? After a brief discussion on how the reforms brought about transformation in different sectors of the economy, I would like to flag some of these contentious issues.

The Indian economy has registered an impressive growth in recent times with GDP recording an average of 7.2 per cent growth rate in the current decade from an average growth of 5.7 per cent in the nineties. A comparison with the earlier period since the beginning of the last century brings out the extent of economic transformation far more clearly. During the first 50 years of the nineteenth century the average GDP growth rate has been just 0.7 per cent which picked up to 3.5 per cent (popularly called as "Hindu rate of growth") in the next three decades after independence, before progressing to higher growth path in the recent decades. Concomitantly, the per capita income grew from a mere 0.2 per cent in 1900-1950 and 1.1 per cent in 1951-1980 to 3.2 per cent in the eighties and 3.6 per cent in the nineties and further to 5.4 per cent in the current decade (Table 1).

Table 1: Structural Change in GDP *(Growth Rate)*

	1900-1950	1951-80	1980s	1990s	2000-09
Agriculture & allied activities	-	2.1	4.4	3.2	2.8
Industry	-	5.4	6.4	5.7	6.5
Services	-	4.5	6.3	7.1	9.0
GDP	0.7*	3.5	5.6	5.7	7.2
Per Capita Income	0.2*	1.1	3.2	3.6	5.4

*Angus Maddision (2007): The World Economy, OECD.
-: Not Available

Transformation of the economy is quite apparent from the noticeable changes that have occurred in the sectoral composition of output. The share of services in the national income has steadily increased with corresponding fall in the contributions of agriculture and industry over the years. Services sector now accounts for nearly two third of total output as against less than half in the early eighties and the nineties. Share of industry declined marginally to 19 per cent from 20 per cent whereas share of agriculture registered steep decline from 38 per cent to just 17 per cent (Annex 1).

This positive performance seems to be an outcome of reforms encompassing a range of measures that led to transformation spreading over all the sectors of economy. Transformation brought in higher degree of sophistication and efficiency in operations of almost all the sub segments of real as well as financial sectors. Moreover, domestic economy has become far more integrated with rest of the world which is visible not only in terms of growing trade volumes; financial flows from and to the outside world have also been steadily growing. There are some experts who argue that India's economic transformation needs to be attributed to change in policy orientation of 1980s rather than the reforms undertaken during 1990s. Although they do recognise the possibility that improvement in 1980s might have run out of steam without further reforms undertaken in the nineties (Subramanian, 2007). While, academic debate as to what triggered the economic transformation might still be unresolved, there is a near consensus with regard to the important role of liberalisation process initiated in the early nineties in placing the economy on a higher growth path.

The economic reforms that ushered in 1991 put forward some important political questions. The first question comes to our mind is about the timing of the reforms i.e. why the reforms were started only in 1991 and why not earlier? How the process of reforms continued despite changes in ruling party at the centre? How the direction of reforms sustained and remained irreversible despite various hurdles and hiccups? The answers to these questions, to a large extent, lie in the transformation in political spectrum of the Indian electoral democracy. As one avid follower of India's economy puts it, " --- the greatest change in the last 10 years has been in the attitude towards reforms. Whereas the vocal supporters of reforms within India were rare during the 1980s, virtually every political party today recognises the need for continued reforms" (Panagariya, 2008).

Besides brewing up of twin economic imbalances i.e. fiscal crisis and external payment crisis, the timing of reforms may have been the outcome of international and domestic political events. Internationally, two major events questioned the basic premise of our earlier social consensus regarding the development strategy. First was the collapse of erstwhile USSR and the East European socialist regimes and their march towards market oriented economic system. Second, the spectacular success of "socialist market economy" of China with the aggressive opening up since 1978 and its associated success in poverty reduction raised concerns about the efficacy of India's inward orientated strategy. Domestically, the appreciable growth performance of 1980s which was induced by hesitant liberalization efforts strengthened the hands of pro-liberalization minority in the bureaucracy and in the Government that has been instrumental in systemic reforms in the 1990s. (Tendulkar and Bhavani, 2007).

The continuation of reform process and irreversibility of its direction could be explained with three interlinked political developments. First is the emergence of regional parties and their increasing hold in national politics. Second is the beginning of the era of coalition Government at the centre. Third is the growing and widespread acceptance of the need for rapid economic growth that can be achieved by the market-oriented reforms. Besides, competing claims of various states on benefits of economic reforms has also helped in sustaining the momentum of reform process in India. During the reform period some states have performed well while others have been lagging. This has been the effect of policy environment and the quality of governance at the state level. Those states, which reorganized their policies in favour of market oriented reforms in tune with national economic policy framework and provided hassle free investment environment to entrepreneurs, have reaped more benefits of economic reforms in terms of high growth and per capita income.

Let us now see how the reform process has brought about transformation in each of sub sectors of the economy.

Economic transformation – real sector

Real Sector Policy measures mainly focussed on the manufacturing sector in the early stages of reform process. Deregulation of industry by way of eliminating licensing requirement, overhauling of public enterprises, enhanced role for private sector, abolition of MRTP Act, automatic approval route for foreign investment, elimination of quantitative import restrictions and reduction in tariff rates crated a conducive environment to gear up the industry to face growing domestic as well as external competition to which it was exposed by the reform process. Another area where reforms came about at a later stage related to de-reservation of large number of items that were earlier meant to be produced exclusively in the small scale sector. Measures were further supplemented with liberalisation of foreign direct investment not only in terms of scope and proportion of foreign ownership but also with regard to procedural details. Industry responded to reforms by undertaking massive restructuring of its operations by upgrading their technologies, expanding to more efficient scales of production, resorting to mergers and acquisitions both within and outside the country and refocusing their activities to the core competence.

While manufacturing became more competitive and efficient, major impact occurred with respect to services sector. Entry of private sector and foreign direct investment that introduced competition and state of the art technology brought a sea change in the services sector. For instance, there was a time when telephone was a luxury and customers had to queue up for years to get a connection. Now it is available on demand. Mobile phones have reached to the lowest rung of the society and have played a key role in integrating the far flung areas to the main stream. Synergies provided by the manufacturing sector, liberalisation of financial sector with entry of private sector in areas hitherto restricted to public sector and policy initiatives with regard to information technology led to surge in growth of services sector.

The boom in information technology (IT) and Information Technology and Enabled Services (ITES) sector essentially led to an era of “services-led growth” as India emerged as global hub for BPO/KPO services in the world. This shift in the pattern of off-shoring services to India was mainly due to inherent advantages of Indian IT/ITES sector. Advantage of the low wage structure, flexibility due to time zone differences and access to a larger and better talent pool provide globally active companies, India as an ideal place, to look for off-shoring services.

In the last two decades, the Indian IT/ITES industry has contributed significantly to Indian economic growth in terms of GDP, foreign exchange earnings and employment generation. Indian IT/ITES sector’s contribution to the country’s GDP has been steadily increasing. As a proportion of national GDP, the IT/ITES sector has grown from 1.2 per cent in FY98 to 5.2 per cent in FY07.

IT to an extent has generated the employment opportunities for both skilled and unskilled labours. The direct employment in the IT/ITES sector was expected to be 2.0 million by end of FY08 and has been growing at a compounded annual growth rate (CAGR) of 26 per cent in the last decade. Studies have shown that for every one job created in the IT/ITES sector, four additional jobs are created in the rest of the economy.

Socio-economic dimension, that lends uniqueness to India’s pattern of growth and economic transformation, is evident in the relative surge in the growth of industrial and services sectors *vis-à-vis* primary segment. India seems to have skipped the stage of development that emphasises growth in labour intensive industries with absorption of surplus labour from the agricultural sector. As transformation of industrial as well as services sector has overwhelmingly been based on capital intensive techniques requiring skilled manpower, relative shift in sectoral incomes have been devoid of any commensurate relocation of surplus labour and more than three-fifth of population continued to draw its livelihood from the primary sector.

While, foregoing has been the reason for general perception about relative isolation of the agricultural sector from the reform process; keeping with the growing openness, a series of policy initiatives transformed this sector as well. Measures relating to free movement of agricultural commodities, APMC Act permitting farmers to bypass the mandatory requirement of sale in regulated markets and relaxation of restrictions under Essential Commodity Act, 1955 along with introduction of future trading brought major change in the pricing mechanism. National commodity futures markets discover price rather manipulation by local traders. Banks in association with professionally managed godowns extend credit to farmers against warehouse receipts. Large consumer goods companies directly source agricultural produce from the farmers. While, these developments have worked towards improving the terms of trade (TOT) for the agriculture sector, this trend in TOT was also strengthened by lowering of protection for the manufacturing sector and market determined price of foreign exchange. With economic growth and rising disposable incomes, the consumption basket has changed significantly. Growing demand for milk, poultry products and horticulture products, has induced substantial diversification towards allied activities which now account for nearly three fifth of total primary sector output.

Economic transformation – financial sector

Reforms in financial sector complimented the real sector developments. Transformation of financial sector not only assisted in sharp pick up in services sector growth, it helped the manufacturing sector to progress from a high cost to internationally competitive segment of the economy. It was a clear recognition of the role of market forces in price discovery process. Prior to these reforms, pricing of financial resources whether it is bank lending to corporates or borrowings by the Government or the foreign exchange, each of these was determined broadly on the basis of regulator's decision or an administrative fiat rather than its opportunity cost. Cost of resources hardly reflected the underlying situation of a capital scarce economy. Along with free pricing, removal of constraints in terms of participation, type of instruments, market infrastructure and policy environment instilled life in severely underdeveloped financial market segments. While measures were taken to bring financial markets at par with international best practices, it was a conscious decision to go slow on derivative products, a stand amply vindicated by the current global crisis and relative immunity of India's financial sector.

Money market

Reforms in money market were essentially aimed at providing avenues for the market players to deploy or access to short-term funds and a platform to the monetary authority to modulate liquidity in the system. Liberalisation measures in money market preceded the overall reform process as steps related to deregulation of interest rates and introduction of new instruments were initiated in the late 1980s itself. A series of steps over the years viz., freeing of interest rates on call and other money market instruments, introduction of Commercial Paper and Certificate of Deposit, exemption of inter-bank lending from reserve requirement, introduction of screen based trading and rupee derivatives such as Interest Rate Swaps (IRS) and Forward Rate Agreements (FRA), enlarging the scope of Repo market by expanding the repo-able securities and eligible participants in the repo market and introduction of tripartite repo i.e. CBLO to create pure interbank call money market, led to pick up in activity and volumes across the instruments unlike in the past when volumes remained concentrated in call money market.

With steps towards making call market a pure interbank market, turnover progressively switched from call money market to repo and CBLO market as daily average volumes in call market got almost half in 2008-09 from Rs. 23,161 crore in 1999-00. Volumes in case of market repo, on the other hand, rose by two fold during the period and in case of CBLO increase has been four-fold during 2004-05 to 2008-09. Volumes in other market segments such as CP and CD rose as well (Annex 2). Besides, reforms also lent stability to the market as volatility in call market got reduced by nearly half in the current decade from levels prevailing in the nineties (Annex 3).

Government securities market

Till mid-eighties or the early nineties, Government had been borrowing at sub-market rates, a system sustained by captive market created by statutory reserve requirement. As a part of reforms, concessionary financing was eliminated with introduction of market auction system and phasing out of automatic monetisation with Ways and Means Advances (WMA). As yields became market related and Government started competing with the private sector in the market for funds, it had the desired impact on G-Sec market as evident by rising secondary market activity and near emergence of market yield curve. The annual turnover in the market has grown from about Rs 2.8 lakh crore in 1998-99 to Rs. 56.3 lakh crore in 2007-08. Yields on G-Sec now provide bench mark for pricing of securities in other markets.

With reforms, G-Sec is no longer a captive market. Investment in G-Sec by the banks is based on their commercial judgement rather than being dictated by the reserve requirement. Since late nineties, banks' holding of G-Sec have been far in excess of the reserve requirement with ratio going up to near 42 per cent of net demand and time liabilities. Banks progressively off-loaded excess investment in SLR securities from 2004-05 onward in view of the strong credit demand.

Importantly, since April 2006, Reserve Bank does not participate in the primary segment of the G-Sec market that not only provide leeway to RBI in implementing monetary policy, the pricing of Government securities has also become far more market oriented. Beside these core aspects, development of the market was sustained by up-gradation of technology and market infrastructure with regard to settlement systems and trading systems and amendment of legislative provisions.

Foreign exchange market

Prior to reforms, foreign exchange market was virtually absent. Exchange earners were required to surrender/ purchase foreign exchange from Reserve Bank at the reference rate. In this highly regulated system, very few transactions used to take place among the authorised dealers and trades were required to be squared off by the close of the day. Introduction of market based exchange rate regime, adoption of current account convertibility and relaxation on capital account, *inter alia*, in terms of permission to run open positions, to hold investments abroad and to retain foreign exchange along with introduction of hedging tools (derivatives) led to emergence of active and vibrant foreign exchange market. Now exchange rate is flexible and market determined; and capital account is also effectively convertible for the non-residents.

It is interesting to note that with significant liberalisation on the capital account and given that market forces play a predominant role in determining external value of the rupee, there has not been large volatility in this market barring few mild episodes related to turbulence in global markets. Daily exchange rate volatility in rupee had been in the range of 1.6 to 4.7 per cent during 2001 to 2006 as compared to 7.5 in 1993-95. It is lower than most of the emerging economies. Computed from monthly NEER and REER indices, volatility in Indian market is one of the lowest in the world. Reform measures enhanced depth and liquidity in the market reflected in rising turnover and moderation in bid-ask spread over the years. There has been more than four-fold rise in total annual turnover in foreign exchange market from US $ 1.3 trillion in 1997-98 to US $ 5.7 trillion in 2006-07.

Capital market

Like other market segments, there have been far reaching changes in both the primary and secondary market segments of capital market. Primary market witnessed a significant movement away from CCI regime imposing primary issuance at sub-market rates to free pricing and book-building system along with mandatory disclosures as prescribed by SEBI. In the secondary market, corporatisation of exchanges, screen based trading replacing open outcry system, introduction of options and futures replacing erstwhile *Badla* System, rolling settlement replacing 14-day settlement cycle, dematting of securities with depository system created state-of-the art infrastructure comparable to best international practice. This not only integrated stock markets across the country, capital market became far more efficient as could be observed in terms of various parameters. There has been sharp increase in liquidity as observed from fall in impact or transaction cost by more than 50 per cent and rise in turnover ratio from 20.3 per cent in 1991-92 to a peak level of 409.3 in 2000-01 before moderating to 81.8 per cent in 2006-07. Similarly, in terms of market stability, volatility declined from 3.3 in 1992 to 1.1 in 2005.

Credit market

Prior to reforms, banking operations both on the assets and liabilities side were governed by the guidelines set out by the regulator. With guidelines that ensured banks' margin on cost plus basis, competition was virtually absent with no incentive to cut cost, raise efficiency or upgrade credit assessment skills. While, broad approach to reforms in this market has been to bring more competition along with higher flexibility and operational autonomy to the banks, stability of the players at the same time was intended to be ensured by emphasising building up of risk management capabilities and introduction of prudential regulation and supervision in line with best international practices. Moreover, widening of ownership due to stock market listing and associated disclosure requirements brought greater market discipline and transparency in the bank management. These measures transformed the banking sector which could be discerned in measures of efficiency and soundness. There has been steady decline in intermediation cost of banks from 6.24 per cent in 1991-92 to 3.43 in 2006-07. DEA based estimates of efficiency and productivity indicates sharp improvement in operations of public sector banks and are now comparable to their counter parts in the private sector (RBI, 2008). Growing soundness of the banking sector is also evident in falling NPAs from 7.7 per cent in 1995-96 to about 1 per cent in 2006-07.

While banks' operations became more efficient, there has been considerable progress in terms of business volumes reflecting growing economy and reach of the banking sector. Over the past 11 years, on an average, deposits of scheduled commercial banks have risen at a compound growth rate of 17.7 per cent and advances grew by 21 per cent. Growth has been higher for urban and semi urban branches compared to rural branches. In terms of advances to various sectors of the economy banks' portfolio has been quite diversified. Since, 1998-99, while share of advances to agriculture sector remained around 12 per cent, there has been progressive diversification from industrial and wholesale credit to segments such as professionals, personal loans, etc (Annex 4).

Payment systems

The rapid developments in the Payment Systems and technology have led to the deeper penetration in terms of increase in the number of direct and indirect participants and market players in the payment systems. Among the major developments in recent times, the enactment of the Payment and Settlement Systems Act, 2007 empowering the Reserve Bank to regulate and supervise payment and settlement systems, lay down policies and providing a legal basis for multilateral netting and settlement finality, is of great significance. Another recent development has been to make free the use of other bank ATMs with effect from April 1, 2009. The service charges for "Electronic Payment Products" and outstation cheque collection have also been rationalised. "Speed Clearing" has been introduced to reduce the time taken for realisation of outstation cheques to T+1 or T+2 basis. "Cheque Truncation System (CTS)" has been introduced in cheque clearing since July 2008 in New Delhi. The coverage of Electronic Clearing System (ECS) has been increased to 75 centres and 89 banks with 55, 225 branches are participating in National Electronic Funds Transfer (NEFT) system.

In terms of payment systems growth, the *Real Time Gross Settlement System (RTGS)* volume has gone up from a modest 17.67 lakh in 2005-06 to 133.6 lakh in 2008-09, and the value has gone up from Rs.1,15,40,836 crore to Rs. 3,22,79,881 crore in the corresponding period. The retail *Electronic Clearing* volume has gone up from 8.3 crore in 2005-06 to 28.06 crore in 2008-09, and the value has gone up from Rs.1, 06,598 crore to Rs. 4, 16,419 crore in the corresponding period. The *MICR Cheque Clearing* volume has gone up from 101.59 crore in 2005-06 to 114.04 crore in 2008-09, and the value has gone up from Rs.54, 01, 429 crore to Rs. 58, 49, 642 crore in the corresponding period. The *Cards* volume has gone up from 201.77 crore in 2005-06 to 387.21 crore in 2008-09, and the value has gone up from Rs.39,783 crore to Rs. 83,903 crore in the corresponding period. The spread of *ATMs* has increased from 34, 789 in March 2008 to 43, 651 in March 2009 and the volume of ATM transactions has increased from 17,797 lakh in 2007-08 to 23,530 lakh.

These data suggest that the payment systems in India are robust, sound and have been growing at a steady pace.

Economic transformation – integration with the global economy

Another aspect of developments in India's economic arena that facilitated the process of transformation by enabling rapid growth of services sector and change in character of manufacturing sector in terms of efficiency and sophistication with considerable outward orientation, relates to its growing integration with rest of the world. The most common measure of country's integration with the global economy is its openness, i.e., its participation to international trade and capital flows. In India, the share of merchandise exports to GDP increased from 5.8 per cent in 1990-91 to 15.1 per cent in 2008-09, the share of merchandise imports as a per cent to GDP, on the other hand, increased from 8.8 per cent to 25.5 per cent during the same period. On the import side, India's demand for primary products, viz., raw materials and energy has increased since 1990s, which may be linked to its rapid economic growth. In 2007, India was the 7th largest oil importer of the world. While, India's merchandise trade has grown many folds in the current decade, during 2008, India ranks 26th in the world with a share of 1.1 per cent. However, in terms of commercial services exports, India ranks much higher at 9th in the world with a share of 2.7 per cent.

In terms of capital flows, India has emerged as one of the most favoured destination of global investment among the developing and emerging market economies. Net capital inflows increased from US $ 7.1 billion in 1990-91 to $45.2 billion in 2006-07, and further to $108.0 billion during 2007-08. The gross volume of capital inflows, however, amounted to $428.7 billion in 2007-08 as against an outflow of $320.7 billion. Overall, India's total transactions with rest of the world (current receipts plus current payments plus capital inflows plus capital outflows) increased from 31.4 per cent of GDP in 1990-91 to 119.7 per cent of GDP in 2007-08 before declining marginally to 112.4 per cent of GDP in 2008-09 in the wake of global financial crisis.

This growing integration of Indian economy with rest of the world was essentially an outcome of reform measures triggered by BOP crisis in 1991. Apart from a swift transition to a market determined exchange rate regime, other important reforms measures included dismantling trade restrictions, moving towards current account convertibility, liberal inflows of private capital, removal of restrictions on all inflows and related outflows, as also, gradual liberalisation of certain restrictions on outflows.

Trade liberalisation

De-licensing of virtually all intermediate inputs and capital goods, progressive reduction in tariff rates along with permission for all current business transactions, expenses for education and medical and foreign travel enabled India to accept IMF Article VIII obligation thereby making rupee convertible on current account as early as in 1994. Further liberalisation with regard to import licensing for consumer goods and reduction of tariff rate below 10 per cent (barring few exceptions, such as automobiles) considerably enhanced the outward orientation of Indian economy.

Capital account

Although, the external payment crisis of 1991 brought to the fore the need for debt-dominated capital account financing, the move towards full capital account liberalisation has been calibrated with extreme caution. The broad approach that characterised the policy framework for capital inflows involved supplementing debt capital with non-debt capital with a clear prioritisation in favour of the latter.

Foreign direct investment

The major policy thrust towards attracting foreign direct investment (FDI) began in the early 1990s by introduction of automatic approval route that empowered RBI to approve equity investment up to 51 per cent in select 34 priority industries. Currently, unless there is specific restriction contained in FDI policy, 100 per cent foreign investment is permitted under automatic route. A very limited number of activities fall under this category viz., retail trading, atomic energy, lottery business, gambling and betting. Again, the list for FDI cap below 100 per cent is also quite short including broadcasting, print media, defence, insurance, asset reconstruction, investment companies, petroleum and air transport.

Portfolio investment

Portfolio investment both in primary and secondary market by Foreign Institutional Investor (FII) was opened up in 1992. At the same time, Indian companies were permitted to raise equity finance through issue of GDR and ADR in Europe and American markets. Policy with regard to FII investment was progressively liberalized with total FII share in equity being raised from 24 per cent to total sectoral cap on foreign investment. For majority of sectors this cap is 100 per cent. Beside, FII are permitted to invest in debt instruments issued by both private corporate and the Government, and they can operate in forward market to hedge their currency risks.

External commercial borrowings

Permission to access ECB further contributed to integration of India's financial sector with rest of the world with corporate increasingly compared the cost of financing and switched between ECB and the domestic bank credit. In the recent years, corporate have increasingly accessed commercial borrowings from abroad with net inflow on account of ECB rising from USD 5 billion in 2004-05 to more than USD 22 billion in 2007-08. However, the policies towards ECB that inter alia include bank loans, buyers' credit, suppliers' credit have been guided by the overall consideration of prudent external debt management by keeping the maturities long, cost low and priority for projects in the infrastructure and core sectors.

Outward flows

In line with liberalized regime with regard to inflows, outward capital flows were also progressively relaxed for both individuals and the corporate sector. Firms can invest abroad up to their net worth plus EEFC holdings and also the foreign exchange raised through ADR/ GDR. This has been a key policy feature that enabled emergence of Indian MNCs in the recent years.

Global crisis and impact on India

Growing integration of Indian economy with the rest of the world essentially explains as to why our economy couldn't remain completely immune to global events though initially, India like many other emerging economies remained impervious to these global developments till as late as October 2008. But for the equity market there has been no direct impact of meltdown abroad on Indian financial sector as reflected by liquidity, turnover and the price movements in various financial market segments. Except for a brief period in September/October, 2008, the transactions were not impeded on account of counterparty concerns since the Indian banking system is prudently regulated, well capitalised and free from "toxic" assets. A closer look at the sequence of events would reveal that impact on the financial sector eventually emanated from the real sector which had a direct impact from the global financial crisis.

Worsening of external environment with Lehman failure caused sudden sell-off in domestic equity markets by portfolio investors reflecting deleveraging. Consequently, the net outflow by portfolio investors was to the tune of US $ 14 billion during 2008-09 against the net inflow of about US $ 29 billion in the preceding year. Besides, access to external commercial borrowings (ECB) and trade credits was also rendered somewhat difficult. Net inflow on account of ECB during 2008-09 was US $ 8 billion approximately as against US $ 22 billion in the preceding year. On the whole, net capital inflows during 2008-09 were substantially lower than in 2007-08. While, reverse flow of capital and constrained external financing adversely impacted the funding of investment, situation also got worsened with downward movement in export of goods as well as services due to sluggish global demand. Growth in exports, on BOP basis, declined from a peak of 43 per cent in Q1 of 2008-09 to -9 per cent in Q3 and further to -24 per cent in Q4. Though, invisible earnings remained stable due to resilience of software and remittances, current account deficit rose to 2.6 per cent of GDP in 2008-09 compared to 1.5 per cent in the preceding year. This gradual slowdown in demand, both from within and abroad, eventually reflected in lower growth estimates for GDP in the 3rd and 4th quarters at 5.8 per cent with overall growth rate of 6.7 per cent in 2008-09 against an average growth rate of 8.8 per cent in the preceding 5 year period.

Slower real sector growth had two pronged impact on the financial sector. First, with progressive slowdown of the real sector, bankers/ lenders have become apprehensive and concerned about future rise in non-performing assets, secondly, with global meltdown and liquidity constraints abroad, not only borrowers have increasingly switched to rupee borrowings there has been increased demand for working capital with inventory level rising on account of slowdown in both domestic and external demand.

The series of unconventional measures swiftly initiated by the Reserve Bank helped to assuage liquidity conditions, while reassuring the market that the Indian banking system continued to be safe and sound, well capitalised and well regulated. Overall monetary policy stance has been to provide ample rupee liquidity, ensuring comfortable dollar liquidity and maintaining a market environment conducive for the continued flow of credit to all productive sectors. The liquidity situation has remained comfortable since mid-November 2008 as evidenced by the LAF window where the Reserve Bank has been absorbing nearly Rs.1,20,000 crore (USD 24.5 billion) on a daily average basis during the current financial year. Government policy action to deal with the global crisis has been particularly noteworthy despite its impact on fiscal deficit. Sharp expansion of government expenditure supported the aggregate demand and moderated the impact on overall growth. However, to revert to the higher growth trajectory and to ward off probable inflationary pressures timely exit from expansionary monetary and fiscal stance would be critical.

Do we deserve accolades?

Structural transformation of almost all the segments of the economy during past two decades has brought discernible improvement in terms of efficiency, competitiveness and productivity.

This reflects in economy moving over to higher growth trajectory with far greater integration with the rest of the world in terms of diversification of goods and services as well as destinations to which exports are being made. Of course, we take pride in these achievements and we together deserve it. But, there are enough reasons that we must not get complacent with regard to transformation process. We need to ask ourselves a few relevant questions. How far the benefits of economic progress have percolated down? Whether standard of living of the population has uniformly improved? Can we say economic transformation has brought prosperity to public at large and could we make dent in poverty? I would like to flag and touch upon some of these areas, though do not claim to know the answer for all these questions.

Poverty

In terms of incidence of poverty measured on the basis of consumption expenditure, there is a definite improvement over the years, both in rural and urban areas. There is about 7 to 8 percentage points decline in poverty ratio in 2004-05 over 1993-94 and improvement being more predominant in the rural areas. While these numbers seems to suggest satisfactory improvement, divergence in income distribution has worsened further since the early nineties. Gini Coefficient, a standard measure of income/ expenditure inequality, has further deteriorated from 32.9 per cent in 1993 to 36.2 per cent in 2004. Per capita spending in absolute terms would suggest that there is lot more to be done to fend off hunger and malnutrition. As per NSS 61st round, per capita consumption expenditure of more than 60 per cent population was less than Rs. 20 per day in 2004-05.

Table 2: Incidence of poverty (per cent)

	URP	**1993-94**	**2004-05**
1	Rural	37.3	28.3
2	Urban	32.4	25.7
3	All India	36.0	27.5
	MRP	**1999-00**	**2004-05**
4	Rural	27.1	21.8
5	Urban	23.6	21.7
6	All India	26.1	21.8

MRP-Mixed Recall Period, URP - Uniform Recall Period
Source: Planning Commission

Socio-economic development

Human Development Index (HDI), a widely used indicator of socio-economic conditions has placed India at 132 out of 179 countries in the world in the year 2006 – deterioration from a relatively better ranking of 121 in the year 1990. However, in terms of pure index, India's position did improve from 0.28 in 1990 to 0.61 in 2006, which implies countries in the world have grown and improved their lot much faster than India. This slip in ranking is broadly reflective of poor performance in terms of health and education services as shown by their respective individual rankings (Annex 5).

Health

Since, a transition from high mortality to a state where people generally lead a long and ailment free life is a desirable social goal, India's policies have been focussed on this aspect since beginning and there has been significant improvement over the years in terms of various demographic indicators such as life expectancy, infant and child mortality and maternal mortality rates. However, in terms of international comparison, India slipped further in terms of ranking and continues to lag behind otherwise comparable countries in the world (Annex 6). A little dated report making international comparison of Health care infrastructure, places India below the average of low-income countries in virtually all dimensions (World Bank, 2001).

Resources devoted to health services are much lower in India compared to other countries, even if both public and private sector expenditure is taken into account. Per capita expenditure on health services in India in 2006 has been lowest among select countries – just half of that spent by Sri Lanka and a bit lower than that spent by Nigeria (Annex 7). While poor infrastructure is reflective of a small share of GDP devoted to health services, perhaps efforts need to be made in terms of public-private partnership and appropriate supervision of these services particularly in the public sector. To quote Report of the National Commission on Macroeconomics and Health (2005), "The existing system of primary health care has collapsed in several parts of the country, for reasons other than underfunding".

Education

Indian constitution had set the goal of free education for all children aged up to 14 years by 1960 and recently 86th constitutional amendment has made free and compulsory education to all children of 6 to 14 years of age a fundamental right. Given the enormity of task, Government envisaged to shoulder primary responsibility for provision of elementary education. Overall there is improvement as discernible from gross enrolment ratio, but as per one survey conducted in 2006, 8.9 per cent of children of age 6-14 years in rural areas still remain out of school.

Although, in terms of public spending on education, there has been some marginal improvement from 3.6 per cent of GDP in 1993 to 4.1 per cent of GDP in 2002, reasons for poor outcome lies in sub-optimum performance of Government sector. Teacher absenteeism and achievement level (test score) are worse than low-end private schools. As per one estimate made in 2006, overall teacher absenteeism has been at 25 per cent in India, compared with 16 per cent in Bangladesh and 29 per cent in Uganda (Chaudhary, et al). Apart from these, quality of education is another area of major concern. As revealed by a recent survey assessing quality of education, less than 9 per cent of student in 1st and 2nd grade could read their respective text books. Nearly half of the 5th grade students are unable to read level 2 texts (Pratham, 2006). Improving quality of education and skill formation is important, if we want to encash demographic dividend and retain our edge in services sector. Significantly, China has made considerable progress in modernising its education system in recent years and its gross enrolment ratio is almost approaching twice that of India.

Way forward

Our discussion of process of transformation, its achievements as well as failures do throw up some issues which need to be addressed to ensure that economic progress is sustainable and it is percolating downwards for the benefit of the masses.

Agricultural investment

While structural transformation from agriculture to services led growth is a positive feature, corresponding movement in terms of population dependent on respective sectors has not occurred. The share of agriculture in total income has dropped to 17 per cent; still more than 60 per cent of population continues to draw its livelihood from this sector. This workforce also accounts for sizeable proportion of poor in the country. There is an urgent need to enhance investment in this sector not only to raise crop productivity, but also to create employment opportunities outside the farming. There is a need to effectively integrate rural sector with urban economy by creating needed infrastructure viz., roads in rural areas; electricity; major and minor irrigation projects; and cold-storage chains to provide farm producers access to urban markets. Besides, there is also a requirement felt for bringing legal reforms with regard to tenancy rights that would give a boost to contract farming and higher productivity in farming activity particularly when individual farm size is rapidly dwindling.

Labour reforms

The topic of Labour Laws Reforms in India has always been a matter of debate. The issue here is not to argue whether the Indian labour laws are rigid or liberal, but to find out whether the existing laws are helping in bringing market efficiency and productivity. We have to analyse whether the present laws are encouraging and promoting the growth of the entrepreneurs, creating a positive investment environment and opportunities. There is a need to ensure relativity in the rights of management and workers to promote healthy milieu for growth and progress. A liberal exit policy can only coexist with generous unemployment, retraining benefits and severance pay. One may also need to examine and rationalise some extant labour regulations and provisions. For instance, let us see the pension laws where the workers get the right of pension only after having devoted a minimum numbers of years in the job which in fact restrain them from availing the best opportunities in the market.

The disparity between the organised and the unorganised sectors in terms of working condition and protection of employees' rights also needs to be bridged. There is a need to enhance protection of workers in the unorganised sector with provision of insurance, pension schemes, medical facility and vocational training. In recent times, it has been witnessed that those countries, especially the emerging market economies where the labour laws have been rationalised and more awareness has been created in the unorganised sectors, have achieved higher growth rate of economic development. If we are able to address these issues successfully, we will be deriving many folds benefits of the economic development. Let this critical matter be debated more earnestly at all levels and necessary steps taken urgently, as in India we do not have the type of social security mechanism put in place the way the developed countries have done so in their respective countries to take care and protect the interests of the people.

Demographic dividend

Beside technology, a key factor that has immensely added to India's economic potential is its demographic advantage popularly called as "demographic dividend". Share of the working age group (15-64) in the population has been increasing since the 1980s and has been projected to be in the range of 62 to 68 per cent during first quarter of current century (Annex 8). However, for these demographic changes to provide upward push to economic growth, it needs to be accompanied by process of skill formation and employment opportunities. This would require larger investment in human capital formation and encouragement to entrepreneurial activities by creating conducing environment. Current performance of the education sector particularly in terms of quality leaves much scope for improvement.

Financial inclusion

While financial sector has performed appreciably in the past two decades with gains in terms of efficiency and productivity, it has grown many folds in terms of volumes and thereby supporting overall growth in the economy. However, it is increasingly being felt that benefits of growth have not percolated down to the under privileged sections. While a number of steps have been taken to achieve inclusive growth through various Financial Inclusion initiatives, these are constrained by several factors. High operating cost in remote areas, small ticket size, lack of collaterals and illiteracy have obstructed the steps towards financial inclusion. Today, availability of banking technology has brought the realisation that poor are bankable with good business prospects and hence our efforts should be in the direction of using technology in such a fashion to make the transaction cost cheaper and affordable for the poor.

Conclusion

To sum up, the reform process that began economic transformation since the early nineties has been based on a broad political and intellectual consensus in the country that explains as to why there has never been any policy reversal since then. At times we have been accused to be slow in taking up reforms in certain sectors, but our stance with regard to pace and timing of reforms have been vindicated by our ability to ward off each of the crises that occurred in the global economy.

Transformation of the economy, which is discernible in the form of improved competitiveness, efficiency and productivity across all the sectors, has led the economy to a higher growth trajectory. Consequent shift in relative contribution of various sectors to national income, however, brought to fore the concerns for sustainability of the transformation process and the need for an "inclusive growth". This would require greater focus towards investment in the sectors namely, agriculture and allied activities, small and micro enterprises, and infrastructure. The use of technology to make available "affordable" financial and banking services to the under privileged sections of our society for achieving inclusive growth is also our noble but critical objective. Finally, economic transformation is an ongoing process that needs to be pursued with perseverance and consensus while keeping in view their aptness to the domestic economy. Let us hope that this process continues and gains pace in the coming years.

Thank you.

Select references:

Acharya, Shankar (2004), "India's Growth Prospects Revisited", *Economic and Political Weekly* (October 9).

Ahluwalia, Montek (2002), "Economic Reforms in India since 1991: Has Gradualism Worked?" *Journal of Economic Perspectives*, Vol. 16, no. 3:67-88.

Banga, Rashmi, and Bishwananth Goldar (2004) "Contribution of Services to Output Growth and Productivity In Indian Manufacturing: Pre And Post Reform**s",** Working paper 139, ICRIER.

Bosworth, B., S.M. Collins and A. Virmani (2007), "Sources of Growth in the Indian Economy", Working Paper 12901, NBER.

Central Statistical Organisation (2008), *National Accounts Statistics (Base Year 1993-94)*, (New Delhi: Government of India).

Chaudhury, N. et al, (2006), "Missing in Action: Teacher and Health Care Worker Absence in Developing Countries" *Journal of Economic Perspectives*, 20(1).

Economic Survey various issues, Government of India, *http://indiabudget.nic.in*.

Goldar, Bishwanath (2004) "Indian Manufacturing: Productivity Trends in Pre- and Post-Reform Periods", *Economic and Political Weekly* November 20: 5033-42.

Ifzal A. and J. Zhuang(2007) , "Inclusive Growth toward a Prosperous Asia: Policy Implications", ERD Working Paper No. 97.

Maddision, A. (2006): *The World Economy*, OECD.

Mohan, Rakesh (2007), "India's financial sector reforms – fostering growth while containing risk", Address at Yale University, New Haven, 3rd December 2007.

Panagariya, Arvind (2004). "India in the 1980s and 1990s: A Triumph of Reforms," Economic and Political Weekly, Vol. 39, No. 25:2581-94.

Panagariya, Arvind, (2008), India: The Emerging Giant, Oxford University Press, New York.

Pratham (2006), Annual Status of Education Report (Rural), www.pratham.org.

Reserve Bank of India, Report on Currency and Finance (2004-05).

Reserve Bank of India, Report on Currency and Finance (2005-06).

Reserve Bank of India, Report on Currency and Finance (2006-08).

Rodrik, Dani, and Arvind Subramanian. 2005. "From "Hindu Growth" to Productivity Surge: The Mystery of the Indian Growth Transition," IMF Staff Papers, vol. 52, No.2.

Subramanian, Arvind, (2008), "India's Turn: Understanding the Economic Transformation", Oxford University Press, New Delhi.

Tendulkar S.D. and T. A. Bhavani (2007), "The Political Economy of Reforms: Some Individual Initiatives' in Understanding Reforms: Post 1991 India. Oxford University Press, New Delhi.

UNDP, *Human Development Report*, (various issues), Oxford University Press, New York.

World Bank (2001), "Better Health Systems for India's Poor: Analysis, Findings and Options", Report No. 24124, Washington DC.

Annex 1: Structural Change in GDP (*share in GDP)*

	1980-81	1990-91	2008-09
Agriculture & allied activities	38	31	17
Industry	17	20	19
Services	45	49	65
GDP	100	100	100

Source: Central Statistical Organisation.

Annex 2: Activity in Money Market Segments

(Rupees crore)

Year	Average Daily Turnover #				Outstanding Amount	
	Call Money Market	Market Repo (Outside the LAF)	Collateralised Borrowing and Lending Obligation (CBLO)	Term Money Market	Commercial Paper	Certificates of Deposit
1	2	3	4	5	6	7
1997-98	22,709	–	–	–	2,806	9,349
1999-00	23,161	6,895	–	–	7,014	1,908
2004-05	14,170	17,135	6,697	526	11,723	6,052
2005-06	17,979	21,183	20,039	833	17,285	27,298
2006-07	21,725	33,676	32,390	1,012	21,314	64,814
2008-09	11,218	14,330	30,776	397	47,183	162,574

Turnover is twice the single leg volumes in case of call money and CBLO to capture borrowing and lending both, and four times in case of market repo (outside LAF) to capture the borrowing and lending in the two legs of a repo

Source: Macro-economic and Monetary Developments, July , 2009.

Annex 3: Volatility in Money Market Rates

Item	April 1993-Mar-96	April 1996-Mar-00	April 2000-Mar-07
1	2	3	4
Call Money			
Average (Per cent)	11.1	8	6.3
SD	6.7	3.7	1.9
CV	0.6	0.5	0.3
Commercial Paper			
Average (Per cent)	13.4	11.7	7.8
SD	2.6	2.2	1.8
CV	0.2	0.2	0.2
Certificates of Deposit			
Average (Per cent)	12.2	11.6	6.9
SD	2.2	2.4	1.7
CV	0.2	0.2	0.2
Term Money @			
Average (Per cent)	–	–	6.5
SD	–	–	1.4
CV	–	–	0.2
Market Repo*			
Average (Per cent)	–	–	5.4
SD	–	–	1.1
CV	–	–	0.2
CBLO*			
Average (Per cent)	–	–	5.3
SD	–	–	1.1
CV	–	–	0.2

@ : For the period May2001 to March 2007.
* : For the period April 2004- March2007
SD: Standard Deviation,CV : Coefficient of Variation.
Source: Report on Currency and Finance (2005-06), RBI

Annex 4: Sectoral Deployment of Non-Food Credit

(Share in total)

Year	Priority Sector	of which Agriculture	of which Small Scale Industries	Industry (Medium and Large)	Wholesale Trade (Other than Food Procurement)	Other Sectors (including professionals, Personal loans, etc.)	Non-food Gross Bank Credit
1	2	3	4	5	6	7	8
1991-92	37.4	15.0	15.0	38.8	5.1	18.7	**100.0**
1992-93	35.5	14.2	14.3	41.8	5.0	17.8	**100.0**
1993-94	36.9	14.5	15.5	39.6	5.0	18.4	**100.0**
1994-95	34.7	13.0	15.0	40.4	5.3	19.6	**100.0**
1995-96	33.0	12.2	14.4	41.9	5.4	19.7	**100.0**
1996-97	33.8	12.5	14.3	40.8	4.9	20.5	**100.0**
1997-98	34.6	12.1	15.1	40.8	4.6	20.0	**100.0**
1998-99	35.2	12.2	14.9	40.1	4.3	20.3	**100.0**
1999-00	35.1	11.8	14.1	39.3	4.5	21.1	**100.0**
2000-01	36.0	12.1	13.0	37.9	4.2	21.9	**100.0**
2001-02	36.3	12.6	11.8	35.7	4.2	23.8	**100.0**
2002-03	34.1	11.9	9.7	37.9	3.6	24.3	**100.0**
2003-04	36.2	12.4	9.0	33.9	3.4	26.4	**100.0**
2004-05	38.2	12.5	7.5	35.2	3.3	23.4	**100.0**
2005-06	36.4	12.4	6.5	32.7	2.8	28.1	**100.0**
2006-07	35.2	12.8	6.5	32.2	2.8	29.8	**100.0**
2007-08	33.5	12.4	7.1	32.5	2.5	31.5	**100.0**

Annex 5: Human Development Index – Trend in Select Countries

Country	HDI Index		Life expectancy at birth (yrs)		Adult literacy rate (% aged 15 yrs & above)	
	2006	1990	2006	1990	2006	1990
1	2	3	6	7	8	9
Poland	0.875(39)	0.874(32)	75.3(46)	71.8(32)	99.3(15)	98.0(32)
Brazil	0.807(70)	0.739(59)	72.0(81)	65.6(59)	89.6(98)	81.1(59)
Turkey	0.798(76)	0.671(71)	71.6(87)	65.1(71)	88.1(103)	80.7(71)
Thailand	0.786(81)	0.685(69)	70.0(102)	66.1(69)	93.9(75)	93.0(69)
China	0.762(94)	0.612(79)	72.7(71)	70.1(79)	93.0(81)	73.3(79)
Sri Lanka	0.742(104)	0.651(76)	71.9(83)	70.9(76)	90.8(91)	88.4(76)
Indonesia	0.726(109)	0.491(98)	70.1(101)	61.5(98)	91.0(90)	77.0(98)
Vietnam	0.718(114)	0.464(102)	74.0(56)	62.7(102)	90.3(92)	87.6(102)
Egypt	0.716(116)	0.385(110)	71.0(97)	60.3(110)	71.4(139)	48.4(110)
India	0.609(132)	0.279(121)	64.1(127)	59.1(121)	65.2(148)	48.2(121)

Source: UNDP.

Annex 6 : India's Global position in select Health indicators

	Life Expectancy (Years)		IMR		MMR		CMR	
Country	**1990**	**2005**	**1990**	**2005**	**1990**	**2005**	**1990**	**2005**
Brazil	65.6	71	60	31	230	110	83	33
Chile	71.8	77.9	20	8	67	16	27	10
China	70.1	72	30	23	130	45	42	27
Indonesia	61.5	68.6	71	28	300	420	97	36
Mexico	69.7	74.9	40	22	150	60	49	27
Thailand	66.1	68.6	26	18	180	110	34	21
Srilanka	70.9	70.8	26	12	180	58	35	14
India	**59.1**	**62.9**	**94**	**56**	**550**	**450**	**142**	**74**

Source: HDR, UNDP 2007-08
IMR (Per 1000 Live births), MMR (Per Lakh Live Births), CMR (Under 5 Mortality Rate)

Annex 7: India's Position in Public and Private Health Expenditure

	Private *		Public *		Per capita (US$)	
	2002	2006	2002	2006	2002	2006
Brazil	4.5	3.9	3.2	3.6	216	427
Chile	3.1	2.5	3.1	2.8	263	473
China	3.1	2.7	1.7	1.9	54	94
India	3.6	2.7	0.9	0.9	21	29
Indonesia	1.1	1.2	0.8	1.3	17	39
Mexico	3.5	3.7	2.7	2.9	393	527
Nigeria	3.6	2.7	1.3	1.1	18	33
Sri Lanka	2.2	2.2	1.6	2.0	34	62
Egypt, Arab Rep.	3.6	3.7	2.5	2.6	77	92

*: As percentage to GDP
Source: World Development Indicators

Annex 8: India's Population Projection (in Million)

	Absolute			(Per cent)		
	2006	**2011**	**2026**	**2006**	**2011**	**2026**
1	**2**	**3**	**4**	**5**	**6**	**7**
Below 15 Years	357	347	327	32.1	29.1	23.4
15-64 Years	699	780	957	62.9	65.4	68.3
Above 65 Years	56	66	116	5.0	5.5	8.3
Total	**1112**	**1193**	**1400**	**100.0**	**100.0**	**100.0**

Source : Economic Survey, 2006-07