K C Chakrabarty: Prospects for economic growth and the policy imperatives for India

Address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the inaugural plenary of the National Conference on Leadership, at the Confederation of Indian Industry (CII)-Suresh Neotia Centre of Excellence for Leadership, Kolkata, 10 December 2010.

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Mr Harshvardhan Neotia, Chairman, CII-Suresh Neotia Centre of Excellence for Leadership, distinguished guests, ladies and gentlemen, let me begin by thanking the organisers for inviting me to deliver this address on a theme which is both topical and of considerable relevance. My objective is to give a realistic assessment of the prospects of India's economic growth, and the policy imperatives to achieve what is within our reach, while also ensuring that we do not fall off the cliff in an attempt to cross the valley. Our success will depend on grooming innovative and focussed leadership at every level of the society.

There are several successful business leaders in the audience and on the dais today at this "Second National Conference on Leadership". The CII believes that in order to succeed in India's mission to achieve sustained growth and competitiveness, the quality of leadership and human resource management plays a very significant role and is one of the key requirements for achieving business excellence. The CII-Suresh Neotia Centre of Excellence for Leadership is facilitating in a big way the growth objectives through the development of leadership and through these deliberations on what policy imperatives are necessary to grow at a rapid pace. I am sure the institute would soon turn into a premier institution of global fame to develop business leaders not just in India but for other emerging markets also.

My talk today would be in two parts. In the first, I would focus on (1) the upsurge in economic growth since the 1980s and further acceleration during 2003–04 to 2007–08, (2) the impact of the crisis and the V-shaped recovery that followed, (3) the near term growth prospects and challenges for India in a world facing multi-speed recovery and (4) long-term growth prospects for India. Part II would contend that in spite of growth success and remarkable near term growth prospects, growth sustainability in India would critically hinge on the following three things: (1) our ability to make the growth process more inclusive, (2) improved governance, and (3) developing leadership in all walk of life. There is some slack in all these aspects, as a result of which India is not harnessing its full long-term growth potential. However, opportunities exist for India to step up its high growth rate still higher.

I

The transformation to the high growth phase

The high growth phase for the Indian economy started from 1980–81 when the economy clearly broke through what was known as the "Hindu Rate of Growth" of 3.5% that represented a low-level equilibrium trap for the Indian economy. Average real GDP growth rate for the Indian economy improved to 5.6% in the 1980s and was distinctly higher than the averages of 3.6% for the 1950s, 4.0% for the 1960s and 2.9% for the 1970s.

What caused this structural shift? In my view, four factors were particularly important. First, the high growth of 1980s was helped by industrial de-licensing and trade liberalization. There was a clear improvement in the growth rates of mining, registered manufacturing and electricity during this period. Second, high fiscal deficits fuelled faster growth, but fiscal deterioration spilled over to twin gaps and on the back of the Gulf crisis, precipitated the balance of payments crisis of the 1991. Gross fiscal deficit (GFD) averaged 6.7% of GDP in the 1980s, compared with just 3.8% in the 1970s. This also resulted in increased monetization of the deficit with net RBI credit to the Centre increasing to 2.1% of the GDP from just 1% in the 1970s thus impinging on the monetary policy efficacy. Third, the saving and investment rates in the economy picked up since the second half of 1970s, laying the foundation for the higher growth in the 1980s. Gross domestic saving rate had improved to 21.2% in 1978–79 from 15.7% in 1974–75, led by improvement in household's financial rate that increased to 6% from 3% over the same period. Correspondingly, the gross investment rate improved to 21.3% from 16.5%. However, saving rate and investment rates stagnated in the 1980s till 1986–87, especially as public sector savings deteriorated after 1982–83. Fourth, structural transformation gathered pace during that decade, with services like trade, hotels and restaurants, transport, communications moving up to a 6% p.a. growth trajectory, real estate surpassing 7% growth and banking and insurance growing at an astounding 10.6%. As a result, in a clear break from the past, non-agricultural sector that was generally growing in 4–5.5% range, recorded a 7.1% growth in the latter half the 1980s.

The high growth phase that started in the 1980s has now lasted for three decades, with the pace of the 1980s being maintained in the 1990s before it accelerated further in the next decade. The average growth rate in the 1990s at 5.7% was statistically not different from that in the 1980s, but qualitatively it was better because efforts were made to reign in fiscal gaps. The GFD/GDP ratio averaged lower at 5.9% in the 1990s. The current account of the balance of payment also showed a remarkable improvement and the period was marked by India starting to reap the gains from globalization. Yet, the industrial growth disappointed during this period and averaged 5.7% in this period; lower than the 6.4% recorded in the preceding decade, as the mining, registered manufacturing and electricity growth decelerated. The growth in the 1990s was mainly driven by the services sector that grew at 7.1% p.a., with impressive activity in most services segments with the exception of storage.

Growth trajectory shifted still higher in the decade 2000–01 to 2009–10. Real GDP growth averaged 7.3% catapulting the Indian economy to the status of the second fastest growing economy amongst the G-20 members. Industrial growth recovered and averaged 6.8% during this decade. Registered manufacturing grew at 8.7%, though electricity decelerated. Services sector posted a growth of 8.0%, with communication sector stealing the show with an annual average growth of 25.3%, banking and insurance growing at 10.8%, construction at 9.2% and hotels and restaurants at 9.1%. High services growth has further changed the structure of the economy. Including construction, the services sector now accounting for almost 65% of the GDP, compared with just about 34% at the start of the planning era. The share of industry has about doubled to 20% from 11% over these six decades, while share of agriculture and allied activities has fallen to about 15% from 55%.

The impact of the crisis & the V-shaped recovery

For three years 2005–06 to 2007–08, the Indian economy grew at an astonishing pace of 9.5% before the global financial crisis caused a global downturn. It could not and did not leave India alone or decoupled. Notwithstanding the coupling and decoupling theorists, it was obvious that with India had substantially globalized. Its trade in goods and services accounted for 48% of its GDP and the economy substantially depended on large capital inflows to sustain its high growth the spillover from the global financial crisis was inevitable.

Inherent resilience arising from India's large domestic demand, a stable financial system, high domestic saving rate, prudent monetary policy and fiscal improvement that followed the FRBM Act, 2003 along with the unprecedented counter-cyclical fiscal and monetary policies helped India cope with the global crisis better than most others. The economy decelerated over the next two years but still grew at 6.7% in 2008–09 and 7.4% in 2009–10. This was in spite the fact that that a cyclical correction in industrial growth had already begun at the start of 2008–09 even before the Lehman struck the financial markets.

Monetary policy reaction was nimble and sizeable during this period. The repo rate was lowered by 425 bps to 4.75% from 9%. The reverse repo rate was cut by 275 bps to 3.25% from 6%. The CRR was slashed by 400 bps to 5% from 9%. SLR was lowered to 24% from 25% for the first time in 11-years. Large liquidity was imparted through MSS unwinding, open market operations, standing facilities and some unconventional liquidity support measures. All this action was taken within a space of 7-months. The moves were coordinated with those in fiscal space that included large tax cuts and an expenditure stimulus. This portrayed a rare exemplary monetary-fiscal coordination that enabled the economy not only to limit the downturn, but also assay a V-shaped recovery.

Industrial growth bounced back since June 2009 and had moved back to a double-digit trajectory by August 2010. The recovery soon spilled over to the services sector, though the economy faced a newer shock from the monsoon failure. The resilience of the Indian economy was still evident as higher rural incomes and greater diversification in rural activity helped agriculture to record a positive 1.2% growth in a year of one of the severest droughts. On back of breezy industrial growth and resumed services sector buoyancy, the output gap had completely closed by Q4 of 2009–10, thus completing the V-shaped recovery.

The near term growth prospects and the challenges

India has now posted an 8.9% growth in each of the first two quarters of the current fiscal year. Purely on the statistical estimates of potential growth, this may appear to be the case of growth surpassing the potential. However, it is important to understand that the growth trajectory has been pushed high on a low base. With these favourable base effects waning away, it may in the short-run be difficult to step up growth without overheating the economy. The near term growth prospects remain very encouraging even if we see slight adjustment in growth numbers ahead arising from unfavourable base effects. We are beginning to see capacity pressures emerge in select industries. It is important to manage both demand and supply conditions and see investment response kick in while maintaining price stability.

Adjusted for base effects, at the moment the economy neither appears to be overheated, nor appear to face a slack. The inflation is above comfortable level but is trending down. The risks to growth remain on either side. On the one hand, the new spell of quantitative easing by some advanced economies has increased the uncertainty about future output and inflation gaps and is risking new short term asset price bubbles. On the other hand, the central banks in the advanced economies are trying to boost short term inflation expectations, but are risking un-anchoring of long-term inflation expectations. We need to be watchful in this uncertain environment and if needed, take speedy corrective responses ahead. However, the direction of change and the relative weights in reaction function that it may be required ahead remains unclear at the moment. The level of capital flows in recent period has been in line with our absorptive capacity, but the potential volatility has to be borne in mind by policy-makers as well as private agents in planning their risk management. It is not without significance that in a world where global imbalances and currency battles have again come to fore, India has managed the impossible trinity without any significant interventions and capital controls. This in many ways reflects a new maturity level for the Indian economy that augurs well for its growth prospects.

The long-term growth prospects

India’s long-term growth prospects remain encouraging but with a larger uncertainty band ahead. With capital stock growing at about 8–9% p.a, working force growing at about 1.9% p.a. and total factor productivity growth exceeding 3% p.a., India can grow at 8% or more. Conventional time series methods based on past data suggest a potential growth rate of 7.5–8% for the Indian economy. However, the issue is how India can move to a 10% growth trajectory ahead. We may think it is difficult to do so in the short-term but we must also realize that for the long-term sustenance of the society, we need to grow by 10% for the next 20 years. The issue is not whether we can or cannot, but what we all must collectively do to ensure that it happens. We also have to see that this growth is inclusive and job-oriented otherwise it will not be sustainable. Only then would we be able to meet the rising aspirations of the newer generation. We are at an ever greater risk of social cohesion collapsing should the growth fall from here. Herein lay the challenges for our leadership in various walks of life. Herein lay the policy imperatives that are needed to deliver this tough goal.

India has demographic dividends to support its growth ambitions. The share of working age population of 20–59 years may rise from 49% in 2000 to 55% in 2025 and stay still high at 53% by 2050. India's old age dependency may be just 12% in 2025. This is in stark contrast to the ageing populations in many OECD countries, where dependency ratios are rising fast. In Japan the dependency ratio is set to rise from about 30% in 2005 to over 70% by 2050. Old age dependency ratios in EU countries are also rising fast. They are projected to go up from about 26% now to about 53% by 2050.

India's growth story also has potential to benefit from rapid urbanization. The share of urban population in total is also rising rather rapidly. It was below 20% in 1971, but has climbed to 29% by 2001 and is projected to rise to 37% by 2016. However, both demographic dividends and the urbanization can be a great promise or a potential nightmare for the future depending upon what we do. For example, over 20 million Indians can potentially join workforce every year, but we are creating job opportunities at a rate of roughly 7 million annually over the last three decades of high growth. We need to step up our focus on how to reap the best from the demographic dividends and rapid urbanization. This would require increased resource allocation and resource generation in activities like education, health, urban and rural infrastructure. It would require efforts to bridge energy demand-supply gaps, new investments in renewable energy and stepping up mineral exploration. We need to do more to remove factors that might constraint future growth.

II

What policy imperatives are needed to push the potential or macro-economically sustainable growth rate up? As I had mentioned, I would discuss three sets of policy imperatives.

Making growth process more inclusive

India has been a remarkable growth story for the last decade all right. However, the growth process has not been very inclusive. There are several indicators that would leave us uncomfortable with the current growth process. According to the United Nation's Development Program (UNDP)'s Human Development Index (HDI), 2010, India was placed at a rank of 119 amongst 169 countries, which is clearly not in sync with India's economic strength. Almost all our competing emerging market economies including Malaysia, Russia China, Sri Lanka, Thailand, Philippines, Indonesia and Vietnam have better HDI rankings than us. India's relative position has not improved very much over the years, with a rank of 77 amongst 95 countries in 1980 and a rank of 95 amongst 118 countries in 1990. This may not be surprising once we consider that we spend only less than 3.5% of GDP on education, ranking 117th amongst 142 countries and comparing poorly with countries like Lesotho and Cuba that spend 14% of their GDP on education and Botswana that spends 10%. We spend just 1% of our GDP on public health services and rank a dismal 181 amongst 188 countries ranked in terms of HDI indicators. Small countries like Kiribati and Marshall islands spend 14% of GDP on this and Cuba spends 9%. Most OECD countries spend 6–9% of their GDP on public health services.

Rapid growth has made a dent on poverty, but perhaps not enough. Over a quarter of our population still lives below the poverty line. Based on National Sample Survey (NSS)'s 61st

Round, the poverty ratio was 27.5% in 2004–05, with 28.3% in case of rural areas and 25.7% in case of urban areas. However, these ratios compare well with those in 1993–94 which were 36.0% at All-India level, 37.3% in case of rural areas and 36% in case of urban areas. 42% of India's population earns less than US$1.25 per day on PPP basis. According to some estimates, more than half of country's wealth is shared by only 10% of the population. However, India's income Gini coefficient is 36.8%, which compares favourably than most emerging markets. As per the latest round of NSS, the unemployment rate in 2007–08 was 8% on the current daily activity status. India's health and education statistics are disappointing even by the developing country status.

An inclusive growth process goes far behind income redistribution. It embraces a long-term growth framework with a view to ensure that segments of population do not get excluded from the growth dividends. The process goes far beyond poverty reduction strategy and to my mind is build on four pillars – (1) empowerment of the poor through provision of health, education and skill formation, (2) financial inclusion by improving the reach of institutional finance to the poor and (3) entitlement to food and nutrition and (4) asset creation, especially housing with water, electricity and sanitation so that poor gets shelter and is able to work therein or around and generate steady source of income to live a sustainable his livelihood.

I see financial inclusion holding the key to more inclusive growth. India's remarkable growth story cannot be sustained in absence of rapid strides in financial inclusion. The targets under priority sector lending, the banks' linkage to the Self Help Groups (SHGs), the introduction of Kissan Credit Cards (KCC), the regulatory nod to the Business Facilitators (BC)/ Business Correspondent (BC) model, the introduction of the no-frill accounts have been some of the several steps facilitated by the Reserve Bank to promote financial inclusion.

However, a lot more needs to be done. As many as 145 million households or about 43% of India's population still do not have access to banking. Regional disparities further compound the problem. The Report of the Committee on Financial Inclusion (Chairman: Dr. C. Rangarajan) states that about 95% of the farmer households in the North-East do not have access to formal finance. At an All-India level 49% the farmer households are indebted, though the level of their indebtedness to the formal sources is less at 27%. About 10% of the population has life insurance coverage. Over 90% of the villages still do not have bank branches. Banks are today working with micro-finance institutions in many parts of the country in their quest to reach out to those who have been excluded. However, the challenge remains gigantic and would need to be provided by the mainstream lending institutions.

Capital formation in agriculture has started to pick up again, though the mainstream lending institutions could do more to support this process. The gross capital formation in agriculture and allied activities has increased to Rs1,38,597 crore in 2008–09 from Rs78,848 crore in constant (2004–05) prices. This is 76% increase that betters the 51% increase in case of all industries. However, we still have missing growth in relation to the potential that the agriculture sector holds. India's yields compare poorly in relation to world standards. India's yield of foodgrains has improved only marginally over last 10 years to 1798 kgs/hectare in 2009–10 from 1704 kgs/hectare in 1999–2000 and compares poorly with global average of 4168 kgs/ hectare. The yield of paddy in Egypt is as high as 9731 kgs/hectare and the yield of wheat in UK is 8281 kgs/hectare. While the yields have a lot to endowments, they are also a function of our technology, investments and institutional arrangements. Not all the yield gap is explained by different initial endowments. One needs a better understanding of the reasons why foodgrains yield in U.P is 56% of that of Punjab or in case of Bihar it is just 42%. In Maharashtra it is just 24% that of Punjab. Agri business leadership need to partner state interventions in stepping up productivity keeping in view regional conditions. Only then can we generate the supply response to push agricultural growth up.

Improved governance leading to better delivery model

Over the last decade, growth theorists and development experts have realized that governance goes a long way in explaining growth. Good governance refers to good order and workable arrangements that cover a wide array of institutional arrangements including regulatory and legal framework which are a must to ensure a cost-effective delivery model for the entire range of products and services. In India, we have created many institutions in this direction over the last two decades. However, we do not still compare well in terms of governance indicators. In terms of the World Bank governance indicators developed by Kaufman, Kraay and Mastruzzi, India ranked at about 46th percentile in 2009 based on a range of indicators that are considered, implying that more than half of the 210 countries studied score better on governance. Our governance deficit can be reduced through faster decision-making and speedier implementation of all types of projects we engage in; be it safety nets, social infrastructure, road, other transportation or power or telecom projects.

Striking a fruitful public-private partnership holds the key to improved governance. On the one hand, the enabling environment for the business needs to improve further. On the other, the business leadership needs to focus more closely on investment project deliveries and bridge the wide chasm between planned investment and actual capital formation at the grass-root level. According to the World Bank database for 2009, it takes on an average 30 days to complete the procedures to legally start operating the business in India that puts it at a rank of 113 amongst 182 nations. In 29 countries it takes a week or less to start a business. New Zealand tops the chart as you can do so in just 1 day. In Australia it takes 2 days and in Singapore 3 days. Similarly, it takes in India 271 hours to prepare and pay taxes, ranking 114 amongst 182 nations. India scores even worse in bankruptcy resolution. On an average it takes 7 years in India to resolve insolvency through settlement of distressed assets through courts. On this score, India ranks 155 amongst 156 nations in the World Bank database, ahead only of Mauritania whereas in troubled Ireland it takes only 0.4 years and in 54 other countries it takes 2-years or less.

If each one of us, whether in public or private sector or as an individual works to capacity, the governance and delivery mechanisms would all improve. We have started to create marvel infrastructure, but it sometimes takes us more than a decade to complete an infrastructure project. There is no dearth of finance to fund infrastructure and experts from the infrastructure finance industry tells me that no commercially viable project that has the requisite clearances and the input availability is suffering because of lack of debt finance. There is no dearth of initiatives undertaken to step up infrastructure investments. The Viability Gap Funding (VGF), enhanced financing by infrastructure finance companies, takeout financing, model concession agreements, annuity based funding are few examples. What is required today is commitment for speedier implementation. We still have glaring gaps in infrastructure. We still have about 9% energy shortage. Large transmission and distribution losses, estimated at nearly 40% and absence of adequate competition impacts electricity industry. At least 7% output is lost due to electrical outages. As a result, India's per capita electricity consumption at 542 kWh is only 4% that of United States and 1.5% that of Iceland. Our infrastructure deficit is reducing at a slow pace and we need to accelerate implementation of our plans. A lot may have been achieved in terms of the Golden Quadrilateral project and NHDP Phase III, but the road deficit remains large in terms of the ambitious but needed target of creating 20 kms of road every day.

Business leadership with integrity and vision can make a difference to our Governance. There are several areas where governance can be improved. This range from safety net delivery to corporate governance in our most dynamic of the businesses. We can easily push up our growth by at least 1-percentage point by improving governance. We can improve a lot other economic parameters including the fiscal deficit also. What we need to aim at delivery mechanisms to speed up project implementation in all walks of life.

Providing leadership

While economists recognised that governance matters for growth, they have had little recognition for the role of leadership in the same. Leadership issues were left to the management experts. Yet, to my mind, leadership plays a vital role in growth and development in a society. The right leadership can ensure a number of things that include inclusive growth, green growth, good governance, entrepreneurship, economic stability, peace, social cohesion. All of these ultimately act with force multipliers to deliver not just high growth, but economic transformation. What we need is good political leadership, corporate leadership, managerial leadership and social leadership. In all these walks we need leaders who can transform their workspace. Without leadership, we may grow at an inertial pace for some time but drift eventually.

Take the simple case of provision of education services. Our Prime Minister, Dr. Manmohan Singh, has recognised the centrality of literacy in our growth and development strategy and asked how in this "knowledge century" a third of our people have remained illiterate. We also have the dubious distinction that a third of the illiterates across globe reside in India. There are enough leaders in this country inside and outside the corporate world who can join and own up national literacy as a mission, taking up the challenge of removing illiteracy through social responsibility.

The quintessential Bengali genius Amartya Sen has highlighted the lack of access to basic education as a prime cause for underdevelopment. In my view, it is pity that we could not still implement the Article 45 of our Constitution that required us to provide free and compulsory education till the age of 14 within the first 10 year of our becoming a Republic. This is in the land of Raja Rammohan Roy, Swami Vivekanand, Sir Syed Ahmed Khan, Maharishi Mahesh Yogi and Sarvpalli Radhakrishna. Have we lost leadership now in our quest for greed, bonuses and bureaucratic power? Can we not have innovative solutions that provide a reasonable economic basis for providing basic education to all, while creating more institutions of excellence in different streams of education?

Presently, the country has over 300 million adult illiterates. The drop-out rates at primary and elementary education level are falling supported by the Sarva Siksha Abhiyan and the Mid-Day Meal schemes, but still remain above 25% and 40%, respectively. Today almost all rural habitations are served with at least one primary school. However, over 40% of our primary schools still do not have toilets or boundary walls. The quality of education right from the primary to the higher education stage leaves lot to be desired. The business leadership needs to step in and the public policy needs to create a workable space for private sector to invest in education. Such investment needs to flow in not only in profitable IB schools, but in bridging the gap illiteracy and in technical and skill education.

If India was to truly emerge as the world's leading knowledge economy, the business leadership needs to partner in technical education and skill development. If labour supply is augmented through vocational education and training, the biggest gainers would be business leaders themselves. Industrial Training Institutes (ITIs) can no longer be the preserve of Governments. These need to come up in PPP mode. Of nearly 7 million or more that enter into workforce each year, ITIs are able to supply less than 10% of it. The total number of IT and BPO professional employed in India are rising by nearly 0.2 million per annum currently. We do not have enough supply of trainers. So the leadership needs to grapple with how best to create more IITs as well as more ITIs at the same time.

Business leadership should also look inwards. In an era, where the business leadership frequently looks to banks for debt restructuring, history throws up many examples when corporate leadership can innovatively work out solutions on its own. Take the case of the US airline industry. It has faced a roller-coaster ride over the last 90 years of its existence. At its inception, even though there was no threat from hijackers or terrorists, they found it difficult to sell tickets as people thought airplanes were inherently dangerous. Till 1978, the industry was also overregulated by government, but full deregulation that followed brought new competitive pressures. I would urge you to read the book co-authored by Anthony J. Mayo and Nitin Nohria of Harvard Business School, and Mark Rennella, a former research associate titled "What the Airline Industry Can Teach Us about Leadership". The authors write in the introduction of the book that, "Leaders are change agents who see opportunities and promise where others see only defeat." At each stage of aviation's business life cycle – start-up, growth, maturity, decline, rebirth – new types of leaders emerged. They may have represented different leadership archetypes as the industry went through its life-cycle stages, but they believed in themselves as winners, rather than falling into the trap of looking out for bailouts.

Friends, we have done reasonably well over the last decade or three. But we can do much better. So why not? It is in this context that I drew your attention to the need for a more inclusive growth, better governance and better leadership. We also need to focus more on higher investments in agriculture and rural infrastructure, education and skill development, better health services, scaling up infrastructure investments further by faster execution of projects and speedier delivery. These would work to take us to a 10% sustainable growth path, but we would need to look beyond the narrow business interests to so. An enabling environment through stable macro-economy and a vibrant financial system exists, but improved governance is a necessary condition. We have the elephants and we have tigers within us. We need the leadership that not only takes us higher on growth, but takes everybody along so that each one of us can partner in these efforts and share the fruits. Sharing these thoughts, I leave you all to deliberate further upon the various aspects of leadership and the policy imperatives necessary for future sustainable and inclusive double digit growth.

Thank you!