

## **Y V Reddy: Reflections on India's economic development**

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Council on Foreign Relations, New York, 12 May 2006.

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Friends,

I am greatly honoured by the invitation from the Council on Foreign Relations to interact with you as part of the C. Peter McColough Series on International Economics. I intend sharing with you reflections on India's economic development, not in terms of advocacy or analysis but through a liberal recourse to anecdotes along with some illustrations. By virtue of my experience and background, the remarks may combine a worm's view with a bird's eye-view of the Indian economy, in its broader social context.

In the presentation today, I will –

- a) Provide glimpses of the process of some of the institution building in India that enabled the progress we have made;
- b) Analyse the current macro-economic issues as identified by our recent monetary policy statements;
- c) Assess the outlook for the Indian economy by inviting attention to changing balances;
- d) Illustrate the importance of balance and harmony with reference to reforms in the external and financial sectors; and
- e) Conclude with a discussion on some factors relevant to the prospects for India in the global economy.

### **Institution building**

Among the institutions that constitute strong pillars of current optimism on growth prospects over the long term are: uniquely flexible federalism, democracy with universal adult suffrage, and coexistence of public and private sector. They deserve some elaboration.

At the time of independence, there were genuine apprehensions as to whether India would hold together. It is true that at the time of independence, there were over 500 native or princely states, which had a complex net of relationships with the colonial government in terms of paramountcy. They had to be integrated into a constitutional framework of a federation. The flexibility of the federal structure in the constitution assimilated divergent tendencies as they evolved through a process of political accommodation. For example, in the year 2000, three new States were carved out. We are a Union of States but a number of States had to be created or re-created on several occasions, while boundaries were also altered in some cases. India, as per the constitution, started with Hindi as the official language of the union along with English as an alternate, for a defined period, which again is being extended. The constitution lists national languages which were 14 in 1950 and are now expanded to 22. Every currency note that we print has denomination expressed in most of these national languages. In brief, India has worked hard to build itself into the viable and vibrant political entity that it is today in a short period while encouraging democracy to take roots.

The constitution of USA or the developments in UK first established democracy and then gradually conceded to universal adult suffrage over the passage of a couple of centuries. India started with universal adult suffrage in 1950 and over the decades there has been democratic pressure for rapid and full inclusion of all sections in the mainstream. Other democracies started with equality and conceded affirmative actions as a concession to realities. India asserted the goal of equality but incorporated enabling affirmative actions in the constitution for a specific period – which has been extended from time to time by common consent. Thus, democracy has taken roots in India essentially because of, what Stephen Cohen calls, the genius of Indian people for political accommodation and management.

The expansion of the public sector since independence in this milieu of socio-political transformation has been a major contributor to today's strengths. Expanded educational opportunities, with nominal

fees, led to high quality in education. People could take advantage of the educational opportunities since the process was accompanied by expanding job-opportunities in the public sector, based mainly on performance. In this background, millions were convinced that they needed to work hard at education to be assured of vertical economic and social mobility. The vast public sector has also ensured the mobility of the middle class on a nationwide basis and has guaranteed a vibrant middleclass. This, in turn, produced skilled workers and professionals as well as a large consumer base and a potential entrepreneurial class. The large public sector has co-existed with a private sector though the growth of private sector was sometime enabled and often constrained, by the public sector. The private sector, for its part, learnt to manage, survive and benefit from the public sector while also being constrained by it. In brief, it is the combination of federalism, democracy and the mixed economy that produced a pan-Indian vibrant middleclass of professionals and entrepreneurs.

Thus was built an inclusive democracy that virtually celebrates plurality and yet promotes a self-respecting nation proud of its unity in diversity. We believe that economic development needs to be viewed in this broader context. Prime Minister Manmohan Singh summed up the idea in this very forum – Council on Foreign Relations on September 24, 2004, in the context of Russel C. Leffingwell Lecture :

*“This, (impressive performance) of course is the result of sustained efforts, over the past 50 years to build those institutions that provide the underpinnings of economic development over the longer term, efforts that began early on as part of the vision of India’s first prime-minister, Jawaharlal Nehru. It is also the result of economic reforms which have increased our competitiveness in recent years.”*

### **Select current issues**

Though there are several issues relevant to our economy, in the monetary policy statements in January 2006 as well as April 2006, the Reserve Bank of India flagged three issues as critical for maintaining the momentum of growth with stability, namely, the physical infrastructure, fiscal deficit, and agriculture.

First, the poor state of the physical infrastructure, both in terms of quantity and quality, has been rightly agitating the business class and the policy-makers. There are some reasons to expect a satisfactory outcome, provided the improvement in regulatory framework is sustained. The current investments are demand-led and therefore, are likely to have a short-gestation coupled with a rapid payback on completion. Technological developments and rapid enhancement of domestic construction capabilities should aid the process of speedy and efficient implementation. Given the healthy fundamentals of the domestic financial sector and the enhanced interest of foreign investors, funding should not be a serious problem. When I mentioned my optimistic assessment on these lines in Basel, one of the comments was “with miserable infrastructure, India is already competitive in many areas. I should wonder what happens if the infrastructure really improves”.

Second, fiscal consolidation is taking place both at the Centre and States and there is greater consensus now on the broad directions. The recent budget of the central government brings the consolidation on track, targeting a fiscal deficit of three per cent by 2009 while eliminating revenue deficit. Recommendations of the Twelfth Finance Commission (Chairman, Dr. C. Rangarajan) have reinforced the process to enable further fiscal consolidation at the State level. Our studies on State finances in Reserve Bank of India give grounds for optimism in regard to their fiscal health. From 2003-04, there has been a sharp correction both in the revenue and fiscal deficits; and the process of correction is primarily due to buoyancy in revenue receipts, States’ own tax revenue as well as transfer and devolution of resources from Centre. It is noteworthy that for all the States together, the revenue deficit relative to the GDP is estimated to decline to 0.4 per cent in the current year from one per cent in the previous year and 2.7 per cent in 1990-2000. The corresponding picture for the Gross Fiscal Deficit relative to the GDP is 3.1 per cent compared to 3.7 per cent in the previous year and 4.7 per cent in 1990-2000. However, the issues of power subsidies and ensuring quality in the delivery of services, especially with regards to education and health, do need to be addressed.

Third, and perhaps the most difficult, is agriculture. A majority of the workforce is dependent on agriculture while the GDP growth due to agriculture is marginally above the rate of growth of the population, in contrast to a strong growth rate in the non-agriculture sector. This has generated an understandably widespread feeling of absolute as well as relative deprivation among the farmers and the agricultural labour. While the scope for better terms in the global trading environment is still

elusive, India has a large enough domestic market to facilitate a more rapid growth in agriculture. Yet, legislative, institutional and attitudinal changes to supplement enhanced public and private investment may be needed. The Reserve Bank, for its part, is redoubling its efforts in revitalising the rural cooperative credit system, in strengthening Regional Rural Banks, in providing incentives to commercial banks for investments in rural economy and in ensuring an adequate and timely delivery of credit at an appropriate price. In fact, we are mounting a study of legislation and implementation of non-institutional money lending, as it is the single largest source of credit for the farmers.

### **Outlook - changing balances**

Progress in India is essentially one of shifting balances. These balances shift almost continuously, and often imperceptibly, and it is possible to hold that one way of assessing the outlook for the Indian economy would be to appreciate these changing balances.

First, there is a changing balance in the debates on economic reforms. So far, the discussions have percolated from the English media to the vernacular (with the divide between the English media and the vernacular corresponding roughly to a socio-economic/urban-rural divide). It is interesting to note that while 17 leading English newspapers have a combined circulation of 6.3 million and readership of 17.9 million, 54 leading vernacular newspapers in India have a circulation of 21.4 million and a readership of 197.2 million. Important economic issues are more and more likely to be articulated and shaped by the vernacular media and distilled up to the English media, since it is the vernacular that predominantly represents the rising 200 million middleclass.

Second, there are changes in the vertical balance between Central and provincial or State governments. The trend towards globalisation results in many of the discretionary powers of the Union government in the economic area becoming aligned with bilateral or multilateral requirements while critical areas for role of government in the economy like law and order, education, health, power, water, etc., remain substantively in the domain of the provinces. That a few years ago, many in the world would not have heard of State chief ministers while they do so now, points to an increasing decentralisation of economic reforms.

Third, the horizontal inter-provincial balance is also changing. Now, States are competing for private investments - the drivers of growth – whether domestic or foreign. A competition among the States for the Central government assistance on the basis of backwardness or need, has been replaced with competition for private investments facilitating growth.

Fourth, within governments both at the union and provincial levels, regulatory agencies are expanding their role to reduce the discretionary or possible pro-political cycle authority of governments.

Fifth, the most dynamic element of reform is the mix between public and private ownership of enterprises. The rebalancing of public enterprises is not dramatic but the entry and threat of the private sector and a diversified ownership of public enterprises through partial disinvestment have meant a change in both the operating environment and internal business culture of these enterprises – which, until recently, had employed and retained the largest pool of the best and the brightest. It is no wonder that the equity markets in India have given a big ‘thumbs up’ to many public enterprises, including banks.

Sixth, the enormous and growing diversity in the funding and provision of essential services, such as health and education, is worth exploring. The enrolment in private schools or colleges, often funded through grants-in-aid, exceeds that in public sector in many States. On the one hand, this is positive - since the fees are currently affordable, but on the other, it is a cause for concern since it implies that the public sector is not able to deliver. In the short term, this is a waste of resources and in the long term has the potential for undermining the greatest strength of India – a credible hope for millions, particularly the poor and under privileged, that there is a better tomorrow through better education. The enhancement of the quality of education – primary, secondary and collegiate – in the large public sector is a most difficult yet crucial challenge. Some efforts are being made in this regard by many, such as Azim Premji - the Chairman of one of the largest software companies in India – and the Tatas, one of the largest industrial houses in India. Ensuring access to quality education for the underprivileged in India is an issue that should be of greatest concern to all thoughtful and concerned people of the world. Similar concerns can be raised with regard to the vital area of public health. Here, the private sector is an alternative, though often not an affordable one for most Indians. I am happy to note the efforts of the Bill and Melinda Gates Foundation as well as the participation of McKinsey's Rajat Gupta in the Public Health Foundation of India.

Seventh, there is a dramatic though not fully appreciated rebalancing within the private sector in terms of what may be called the “professionalisation” of industrial houses. A new, highly qualified and professional generation of leadership has replaced the older order in established industrial houses. At the same time, there has been an explosion of an entirely new set of industry leaders, particularly, in newer fields such as software, pharmaceuticals, biotech and financial services. The professionalisation is also accompanied by the globalisation of the operations of the Indian industrial houses.

Eighth, sometimes it is argued that large size is absent in the Indian industry, but it is the wide spectrum of size and diversity that imparts dynamism and generates an entrepreneurial class as well as employment. In the recently held Davos summit, an Indian industrialist referred to two aspects of our business environment. He said that Indian business is often faced with chaos and out of chaos comes creativity. He added that the cost per unit of output may often not be very low in India, but the cost per unit of innovation is!

Ninth, the relationship between labour and management is being gradually rebalanced. It has certainly improved since the 1991 reform. The recent data on strikes and number of working days lost bear testimony to the maturity and wisdom of all concerned. Often, the labour market is cited as a problem but many globally competitive Indian businesses do not seem to perceive it as an insurmountable one. Further, the implementation of provisions relating to labour market under the Industrial Disputes Act, which is broadly in line with international standards, is becoming more pragmatic and less dogmatic in many progressive States. However, the need for greater labour flexibility with attendant appropriate legislative changes, keeping in view the socio-economic conditions, is undeniable.

Tenth, there is often a concern about jobless growth, but in reality it is necessary to distinguish between lack-lustre growth in employment in the organised sector and expansion and intensification of employment in the unorganised sector. By way of illustration, thirty years ago, eighty per cent of engineers or doctors moved into the organised sector, while now, sixty to seventy per cent are self-employed. This implies a shift in the balance from what may be termed as ‘job orientation’ to ‘work orientation’. Despite these positive developments, the greatest challenge before the nation is to create productive work for the millions that are entering the market.

Finally, during the process of reform there is an initial tendency to be pro-business to get quick results while for lasting impact, policy needs to be pro-market. The processes of decision-making, often considered painfully slow in India, are gradually emphasising an increasingly pro-market stance.

### **Reforms in external and financial sectors - balance and harmony**

What are the dominant characteristics of reform in the external sector? On the trade account, the approach was to indicate the direction and to encourage participants to equip themselves better, notwithstanding the risks of anticipatory actions undermining the policy intent. In this context, a distinction needs to be made between promoting growth and enhancing efficiency in the context of economic reforms. Trade reforms in India were designed to enable domestic firms to restructure and spread the costs of adjustments over time – thus enabling enhanced efficiency through a gradual process. Growth is promoted on a longer-term basis in view of efficiency gains that were made possible by the gradualist approach.

On the capital account also, there has been a continuous resetting with a view to the accelerating gradual pace of liberalisation depending on the domestic and global situation but the direction has not been compromised. While there is full convertibility on the current account, and also for all authorised inflows as well as outflows on the capital account, the process of managing the capital account consists of operating two routes, namely automatic and non-automatic. As far as foreign direct investment is concerned, consistent rebalancing in the desired direction is done by expanding the automatic route and by moving most of the prohibited transactions to the non-automatic but approval route and at a later stage, to an automatic or deregulated regime. There is full convertibility for portfolio flows through Foreign Institutional Investors as far as equity markets are concerned. A major area of managing the capital account relates to external debt and the objective in this regard is, in a way, to ensure that short-term debt obligations conform to what is known as Guidotti-Greenspan prescription for avoiding crisis in the emerging economies. As regards residents, a distinction is made between resident individuals, the corporates, and financial intermediaries - and a process of gradual liberalisation for each category, as appropriate, is the general approach. Currently, there is virtually full capital account convertibility for Indian corporates while a roadmap for the future in regard to fuller

capital account convertibility is expected from a recently appointed committee on the subject, by end-July 2006.

The emphasis on balance and gradual rebalancing, keeping in view the desired direction and the need to avoid any roll-back, is thus evident in regard to the external sector and is equally significant for progress in the financial sector - basically following the visionary design of Dr. C. Rangarajan, one of my predecessors. A few illustrations of gradualism may be in order.

First, the Reserve Bank was, till recently, *de facto* obliged to provide money to the government whenever needed, be it through overdrafts or through private placement of government debt with the Reserve Bank or through participation in the primary issues. These have been eliminated with effect from April of this year, but the formal process was commenced in 1997, with a memorandum of understanding with the Government to eliminate automatic monetisation. More recently, private placement or participation was avoided. After being convinced that the new system works in practice, it has been possible to discharge the relevant mandate of the Fiscal Responsibility and Budget Management Act with effect from April 2006.

A second example relates to relaxations in foreign exchange regulations. The Foreign Exchange Regulations Act, 1973 prohibited most of the forex transactions unless exempted, and so, the initial process of liberalisation involved enlarging the list of exemptions. This culminated in replacing the above Act with the Foreign Exchange Management Act in June 2000, where all transactions are permitted unless prohibited or regulated.

A third example relates to competition and ownership of banks. Competition has been enhanced by gradually removing administered interest rate structures, permitting entry of new private sector banks, and expanding the branch network of foreign banks. Unlike in most countries, a branch of a foreign bank in India can conduct any business that a bank incorporated in India may do. On ownership, while over 70% of the banking business was in fully public sector-owned banks ten years ago, it is now less than 10%, since there is a mix of public and private ownership in most of the public sector banks. In fact, in many large public sector banks, foreign ownership is close to domestic private ownership. The two largest private sector banks have foreign ownership of about 70%. The shares of most domestic banks are quoted and traded in local stock exchanges and if stock market is any indication of the outlook, the prospects for public sector banks are bright.

In this process of reform in the banking sector, the legacy problem of non-performing assets were managed by the public sector banks themselves - with no banking crisis or *ex post* fiscal bail out. The government has actually benefited from the infusion of some capital in the public sector banks which was done to comply with the Reserve Bank's prudential regulations. By all accounts, the banking system as a whole has improved in terms of efficiency and resilience gradually, with the mix between public and private and domestic and foreign banks, changing incrementally to enable non-disruptive enhancement of competitive efficiency and stability.

Along with continuous rebalancing within each sector, harmony in reforms across sectors is continuously sought. In a way, the complex tasks of timing and sequencing of reforms in India have been managed through continuous rebalancing within a broadly harmonised policy-framework, often incrementally and rarely in a dramatic fashion. For example, the progress in reforms in monetary management and financial sectors has been impressive, and in the external sector, *de facto*, very significant. Progress in the fiscal sector has not been as rapid, influencing the pace of reform in the financial and external sectors. Similarly, flexibilities in the real economy are necessary if the fruits of marketisation are to be obtained without the attendant risks. Several rigidities, especially in the regulatory environment and the agriculture sector, are being gradually removed and reform in other sectors cannot be out of tune. Finally, clarity in property rights, enforcement, dispute resolution etc., on an expeditious and reasonably predictable basis is also being pursued on several fronts, so that further progress can be made – say, in pricing of risks by banks as efficiently as they happen in developed economies.

Our experience in regard to development and regulation of financial markets differs from that of developed economies. The latter experienced a co-development of markets, regulations, and practices within the economies and at a latter stage, through a process of evolution, integrated first domestically, and finally, globally. In our case, non-existent or underdeveloped domestic market participants had to change their outlook rapidly. The regulators had to develop the requisite skills, and the self-regulatory organisations needed to be founded and strengthened. All these had to take place with narrower degrees of freedom and in a shorter time-span, in view of global developments and financial

integration with its pre-disposed as well as preferred frameworks. The constant plea for the country context in reforms in the financial sector may be viewed in this analytical framework.

## **India and global economy**

There are several complex factors relating to domestic economy that would influence the manner in which India will evolve in and integrate with global economy in the long run. While it is beyond the scope of this address to attempt analysing them, it is proposed to discuss some of these domestic factors namely, trade offs between efficiency and stability; importance of political stability, process of empowerment of women, governance issues and demographic transition.

The balancing of efficiency considerations with stability will be critical in India's successful integration into the global economy. While several observers, especially in the financial sector, hold that India is risk-averse, there are others who assert that a risk-sensitive approach has paid rich dividends both in terms of efficiency as well as stability. Two illustrations may suffice. At a macro level, India is investing around 30% of GDP and recording a GDP growth rate in the range of 7% to 8% - which reflects a high level of macro-efficiency relative to other high growth performers in Asia. Second, at a micro-level, there is evidence of increasing global competitiveness - in particular, in the manufacturing industry despite several handicaps such as the cost per unit of power in India, which is two to three times higher than that in other Asian countries. Also, savings-investment balance is - and perhaps likely to be - reasonable at around 2 to 3% of GDP as current account deficit. Going forward, India's risk-sensitive approach to management may ensure that it contributes to domestic growth and global stability.

Issues of political stability are closely related to those of economic stability - and the stability of the political system in India is noteworthy. The number of coalition partners in the government, number of prime ministers and indeed, of a series of elections to the Parliament and State assemblies in recent years may appear to indicate difficult political cycles. Yet the overall progress in economic and, indeed, social fronts in the recent years, despite the apparently tortuous processes, demonstrates that economic policy cycles do not necessarily go with political cycles in India. There are grounds for optimism on the continued optimal balancing between socio-economic change and political system stability.

No doubt, terrorism is a serious problem but it is a localised problem and the essential fairness of an open multi-cultural society provides hope against any lasting adverse impact on stability. It is significant that there have been attacks on the iconic symbols of India - Parliament, temple, mosque and the Indian Institute of Science. And in all these cases, evidence is that it was driven by the non-residents.

It is useful to recognise the importance of empowerment of women. Let me illustrate with some relevant facts in my home State, Andhra Pradesh. There is a reservation of one-third for women in medical colleges, but as of now, around half the students are women. Of the 92,000 students admitted in engineering colleges this year in Andhra Pradesh, over 30,000 were women. Similarly in the political arena, women are well represented. In the local bodies, there are about 250,000 elected officials ranging from a member of Gram Panchayat to Mayors of Municipal Corporation and chairpersons of Zilla Parishads and of these, over 85,000 are women; and the reservation for women has been operative since 1987. These developments, which are shared in different ways by other States, give a positive twist to the outlook for empowerment of women for the future.

The exploration on the future of India will not be complete without reference to a book by my predecessor Dr. Bimal Jalan with the title 'Future of India : Politics, Economics and Governance'. In particular, he highlights issues relating to enhancing the quality of functioning of the parliament, the bureaucracy and the judiciary. These are complex issues, but the continuation of the good times in the economy is perhaps contingent upon the needed reforms in these areas - sooner rather than later.

India is expected to benefit from the demographic dividend in a global context. It is necessary to recognise that the bulge in the workforce, which is a source of strength, will be concentrated in Northern provinces of India. If education, skills, health and governance are improved to enable a globally competitive labour force, there will be a demographic dividend. There is a greater advantage for India, relative to almost all other countries, in that the demographic transition in India will be stretched over a longer period due to the sheer diversity in demographic profiles among different States. By 2016, in three States - Tamilnadu, Kerala and Andhra Pradesh - the proportion of the elderly as a percentage to the total population will be in excess of 10 per cent. On the other hand,

Uttar Pradesh and Bihar, the two most populous States of India, are likely to have the lowest share at 6.7 per cent and 7.1 per cent respectively. A preliminary observation based on the migration data as per Census 2001 shows that Uttar Pradesh and Bihar are the two States already experiencing the highest number of people emigrating to other States in India. Employment appears to be the dominant factor for migration and this is a positive factor for us. In brief, the demographic profile of India may, in some ways, be mimicking the global profile.

It is interesting that the extreme diversities of the world in terms of languages, religions, ideologies and traditions are reflected in India. There is an overwhelming preference in Indian society and polity for coordination, cooperation and co-option rather than confrontation. In sum, if there is one country that is closest to a well functioning, multi-cultural global village, it is India.

### **Indo-US relations**

In conclusion, some thoughts on Indo-US relations would be in order. The single largest segment of the best and the brightest of India residing outside the country is in the USA, and their assimilation is both smooth and productive. An important source of overseas students in the USA is from India, and the Indian-Americans carry the goodwill for the USA wherever they happen to be. These are among leaders and opinion makers not only in the USA and in India, but also globally. The single largest group of non-resident Indian professionals returning to India to participate in the growth story of India are from the USA. Finally, as Ambassador Blackwell said in this very forum, Council on Foreign Relations on February 23, 2006, in a Journalist Roundtable 'Indians like the United States. According to the Pew Poll, [...] 'India regards the United States more positively than any other country in the world, it turns out'.

Thank you, ladies and gentlemen.