

Y V Reddy: Economic outlook – some thoughts on Asia and India

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Friends,

It gives me great pleasure to be here participating in the 18th Annual Forum. The topic for the discussion is very broad, but there are several eminent speakers here who would be focusing on different aspects of this complex and very relevant issue. For my part, I would, in the first part, make a general reference to the Asian economies, specially the common challenges being faced by the policy-makers in the Asian emerging market economies (AEMEs). The second part will be devoted to the Indian economy, its growth performance, strengths and major challenges. The third and concluding part will be very brief, highlighting the current priorities for macroeconomic, in particular, monetary management in India.

Place of Asian economies in the global economy

It is reasonable to hold that the economies of the Asian region are emerging as the new engines of growth in the global economy. Asia is a host to three of the ten largest economies (China, Japan and India) and accounting for more than 35 percent of world GDP. Today Asia's share in world GDP exceeds that of European Union and the US (IMF, 2006). Being the fastest growing economies of the world, over the past two years, China and India contributed 73 per cent to the Asian growth and 38 per cent to the world GDP growth (IMF, 2005). With the setting in of recovery in Japan, it is expected to be another engine of growth for the Asian as well as the global economy. Thus, four poles of growth – Japan, East Asia, China and India – forming a sort of quadrangle – have been emerging in Asia, and these could henceforth be the new sources for sustaining the global growth engine. It is interesting to note that among the top four economies in terms of GDP based on purchasing power parity, three Asian economies of this quadrangle, viz., China, Japan and India are ranked second, third and fourth, respectively.

It is also important to recognize the growing significance of the Asian economies in financial stability and global trade. For example, there has been a continued substantial accumulation of foreign exchange reserves by several countries of Asia reflecting increasing trade and financial integration of the region with rest of the world. Today, Asia holds foreign exchange reserves of US\$ 3 trillion, which is 62 per cent of total foreign exchange reserves of the world. Further, the Asian region has increasingly become a major center of world trade, global capital flows and other macroeconomic parameters. Today, the contribution of Asia to global trade has increased substantially to about 27 per cent.

Dynamics of Asian economic integration

There is increasing integration within Asia, as reflected in the pace of change in intra-regional trade flows. Intra-regional trade is growing as countries have positioned themselves at different stages of a regional supply chain. The rise of China and India is helping Asia to not only grow but to become more integrated. Asian countries are working to create a cohesive Asian community that allows for both complementary growth and positive competition. This phenomenon has been facilitated by an array of free trade agreements (FTAs) in Asia. Intra-Asian trade as a share of the region's total trade has risen to more than 50 per cent in 2004 from about 30 percent in 1980 (IMF, 2006). In less than 10 years, trade between China and the rest of Asia increased fourfold; trade between China and Japan/Korea tripled over the same period; intra-ASEAN trade doubled, and trade between ASEAN and India has tripled (Mandelson, 2005). In recent years, there is an impressive ongoing transformation in the composition of production and trade within Asia as the comparative advantage of many Asian economies continues to change. In particular, economies with relatively high wage costs are shifting toward higher value-added products, including services. The shift of labor-intensive manufacturing out

of Hong Kong into mainland China and the associated boost to Hong Kong's economy from the growth of trade in financial services is perhaps the most appropriate example of this on-going process.

Financial flows within the region have also become more significant. Although the developing countries of Asia still rely on London and New York to intermediate foreign savings of the region, Japan continues to remain the world's largest exporter of capital. Moreover, Hong Kong and Singapore, with their well-capitalized banks, efficient clearing and settlement systems, and expanding range of financial products, have also emerged as major financial centers. Increasingly, these centers are intermediating savings within Asia, as well as channeling saving to Asia from other parts of the world. In particular, Hong Kong is the main conduit for investment in China and arranges a significant proportion of Asia's syndicated borrowing. Singapore, for its part, has evolved into the main banking center for Southeast Asia.

Asian emerging market economies – some generalisations in the current context

The growing importance of the Asian economies in the global economy and the dynamics of the Asian economic integration are also reflected in the added significance of the Asian EMEs (AEMEs) as the sub-set of the EMEs in the global economy. While the AEMEs are not homogenous in their economic systems, structure and size, it may be useful to consider some generalisations in the current context recognizing the severe limitations of such generalizations whenever a country-context becomes the focus. Developments in the Japanese economy are very critical to the AEMEs and there is scope for considerable applied research in this area, recognising the signs of resurgence in the Japan's economy. The narration that follows essentially relates to the AEMEs, commencing with favourable factors.

First, they currently enjoy strong global demand for their exports, favourable terms of trade and easy access to external financing.

Second, comfortable foreign currency reserves along with reduced external debt as percentage of GDP serve as cushion against any sudden external shocks.

Third, though public debt in some Asian economies still remains at elevated levels, most of the debt is of longer maturity, with higher proportions in local currency.

Fourth, the banking system has been strengthened through restructuring and supervisory systems have improved. Financial markets have evolved considerably in most of these economies.

Fifth, the resilience to external shocks is reinforced by a combination of lower balance sheet exposure to exchange rate risks, lower refinancing risks in debt structures, strong financial systems and above all, an observed tendency for greater policy flexibility.

Sixth, most of the economies display strong growth-performance and reasonably well-anchored inflation expectations.

There are, however, several challenges being faced by the fast-growing AEMEs, particularly in sustaining the hard-won stability while maintaining growth momentum.

First, while growth impulses are strong in Asia and easing of oil-prices should moderate inflationary pressures, there are concerns about inflationary pressures being reinforced by ample liquidity driven by excess capital flows and rapidly rising credit. Strong capital inflows into Asia pose a challenge to monetary management. While some appreciation of currencies of countries enjoying current account surplus is evident, the macro policy may need to be predominantly governed by the compulsions of domestic supply and demand considerations. The currency appreciation or depreciation could, at times, be steep and sudden, resulting in possible disruption in the real sector and therefore there is a need for containing excess volatility in foreign exchange markets. Further, sterilisation costs may have to be often shared between the fisc, the banking sector and the central bank balance sheets. While, to meet the surge in capital inflows, liberal capital outflows are recommended, they do not, in fact, take place at the time when they are liberalised. Further deepening of financial markets may help in absorption of large capital inflows in the medium term, but it may not give immediate succour at the current stage of financial sector development in many AEMEs, particularly when speed and magnitude of flows are very high.

Second, significant improvements have taken place in developing local currency markets, especially bond markets. However, the operations of large players in financial markets in some Asian economies tend to respond more to their global needs than that of host country. Further, some multinational non-

financial corporates operating in these economies may have large treasury operations, and their operations, could often make the assessment of risks in financial markets somewhat difficult. While supervisory skills in many AEMEs have been strengthened, new instruments, especially derivatives, new players such as hedge funds, and large OTC operations tend to diffuse and relocate risks making their assessment for policy purposes sometime difficult.

Third, the banking sector has been strengthened and non-banking intermediation expanded providing both stability and efficiency to the financial sector in many AEMEs. Yet, sometimes aligning the operations of large financial conglomerates and foreign institutions with local public policy priorities remains a challenge for domestic financial regulators in many AEMEs. Further, competition in financial sector is somewhat limited in many Asian economies. Large players in developed economies compete with each other intensely, while it is possible that a few of them dominate in each of Asian financial markets. A few of the financial intermediaries could thus wield dominant position in the financial markets of these countries, increasing the concentration risk.

Performance of the Indian economy

There is widespread and intense interest in the Indian economy, but merely by way of recollecting, it is useful to mention some features of the economic performance.

First, the average growth rate of the Indian economy over a period of 25 years since 1980-81 (financial year beginning April) has been about 6.0 per cent, with the growth rate averaging 9.1 per cent during the last two years.

Second, the economy has shown considerable resilience during the recent years, as evidenced by the avoidance of adverse contagion impact of several shocks in the EMEs and the ability to cope with oil price increases. The strengthening of economic activity in the recent years has been supported by persistent increase in domestic investment rate from 22.9 per cent of GDP in 2001-02 to 33.8 per cent in 2005-06 coupled with more efficient use of capital. Domestic saving rate has also improved from 23.5 per cent to 32.4 per cent during the same period. While the services sector continues to be the driver of growth with a share of around 60 per cent in the overall GDP and contributing almost three-fourth to overall growth, a noteworthy development during the recent years has been the continued recovery in industrial sector, particularly the manufacturing sector, supported by domestic as well as export demand.

Third, the inflation rates since the second half of the 1990s have been by and large benign despite sustained external capital flows and continued surge in fuel prices. In the recent period, the headline inflation as measured by the Wholesale Price Index (WPI) has been higher crossing 6.0 per cent level in January-March 2007 – a matter of concern at this juncture.

Fourth, the common intention of the Government and the Reserve Bank of India is to maintain annual inflation below 5 per cent in the medium term. A welcome development in this regard is that the fiscal position of the Government, both central and States, is undergoing consolidation in terms of targeted reduction in fiscal deficit indicators. The improvement in the fiscal position of several States is particularly impressive.

Fifth, the financial sector has acquired greater strength, efficiency and stability by the combined effect of competition, regulatory measures, policy environment and motivation among the market players including banks. Keeping in view the diverse investor needs in tune with the Reserve Bank's liquidity management, thereby facilitating the conduct of monetary policy, the money market has been progressively developed. The Government securities market is quite deep, liquid and vibrant and well developed in terms of instruments/processes/participants. The exchange rate of the rupee has been flexible, particularly, in the last few years and the turnover in the foreign exchange market has increased considerably. The stock market has been opened to foreign institutional investors and is comparable with major international equity markets in terms of market capitalization, turnover and systems and processes. The corporate debt market in India is relatively under-developed but has a large potential to raise resources particularly for infrastructure projects, housing and for corporate and municipal needs.

Sixth, India's external sector has become resilient with the current account deficit being maintained at very modest levels after a couple of years' marginal surplus. Exports have been growing at an average rate of around 25 per cent during the last three years. Sustained growth in export of services and remittances continued to provide buoyancy to the surplus in the invisible account which enabled

financing a large part of trade deficit. There was a significant strengthening in the capital account with the foreign exchange reserves close to US \$ 200 billion and the reserves currently exceed the country's external debt of about US \$ 140 billion as at end September 2006, thereby reflecting improved solvency of the economy. However, the imparting of human skills needed to cope with global competition is perhaps the most daunting task to ensure employment and thus, social tranquility.

Challenges for the Indian economy

There are, undoubtedly, many challenges for the Indian economy, but it is useful to focus on a few of these: the "usual suspects", I may say, in the eyes of analysts that track the developments in the Indian economy.

First, the poor state of the physical infrastructure, both in terms of quantity and quality is considered to be most critical hindrance for India's progress by many. The most important issue here is regulatory framework and overall investment climate, which are being addressed by the Government. Technological developments and rapid enhancement of domestic construction capabilities should aid the process of speedy and efficient implementation. Given the strengths of the domestic financial sector and the enhanced interest of foreign investors, funding should not pose any serious problem. One other concern has been the cost recovery in infrastructure, which is expected to improve with more public-private partnerships. Again, with rapid growth in manufacturing and services, a sudden and intense pressure has developed in regard to availability and quality of urban infrastructure and urban services.

Second, fiscal consolidation still remains a matter of concern, especially in the eyes of the rating agencies. The recent budget of the central government brings the consolidation on track. Our studies on State finances in Reserve Bank of India give grounds for optimism in regard to their fiscal health. We recognize two important areas that, if addressed would result in fiscal empowerment. One is elimination of subsidies, which are not directly targeted to the poor or inappropriate, and elimination of most of the tax exemptions, which are patently distortionary. While in any polity, fiscal consolidation is hard, it is particularly so in our setting of democratic compulsions, but there are grounds for optimism.

Third, and perhaps the most challenging issue relates to development of agriculture. While over 60 per cent of the workforce is dependent on agriculture, the GDP growth generated from agriculture is only marginally above the rate of growth of the population, which is not adequate to ensure rapid poverty reduction. The results of recent surveys on poverty in India, however, provide grounds for optimism in regard to accelerated reduction in absolute poverty since the reform period. To facilitate a more rapid growth in agriculture, legislative, institutional and attitudinal changes to supplement enhanced public and private investment are needed. There is an increasing recognition of this issue among policy makers.

Fourth, delivery of essential public services such as education and health to large parts of our population is a major institutional challenge. It is strongly felt that education will empower the poor to participate in the growth process and the large gaps in availability of health in terms of minimum access to the poor needs to be filled. Similarly, the judicial processes need to be aligned with the compulsions of a fast-growing globalising economy, especially in terms of timeliness. All these are being intensely debated, and one should hope for significant improvements.

Strengths of the Indian economy

There are certain "not easily quantifiable strengths", which our economy possesses and I would like to highlight them here.

First, a vast pool of science and technology graduates and the millions who are familiar with English language are sources of strength for the emerging India so far. India is a country of great diversities but with incredibly harmonious co-existence of various religions, languages and a unified culture. The familiarity with multiple languages in India prepares the people to adapt better to multi-lingual environment, making it easier for them to fit into international systems very smoothly.

Second, India also enjoys the distinction of being the largest democracy of the world. The existence of a free press provides some insurance against excesses and makes Governments at all levels more alert and accountable.

Third, the political climate is characterised by what may be termed as political system stability, despite the coalition cabinets and periodic elections both at the Centre and in several States.

Fourth, India will remain one of the youngest countries in the world in the next few decades. This "demographic dividend" is seen as an inevitable advantage provided prerequisites such as skill-upgradation and sound governance to realize it are put in place. More important, the demographic transition is likely to be stretched over a longer period since States in India are at different stages of such transition from Kerala to Uttar Pradesh.

Fifth advantage is India's business culture. In terms of business environment, the impressive growth coupled with market orientation of the economy has been a bottoms-up exercise, with a very broad-based growing entrepreneurial class. These tendencies are perhaps reflective of a penchant for innovation among growing entrepreneurial class in India, imbued with professionalism and seeking to be globally competitive.

Sixth, the workers enjoy considerable freedom of movement, expression and rights, especially through unionisation which, while making some changes difficult, ensures a vibrancy and timely improvisation to deal with competition. The migration of labour in India is sometimes seasonal and also related to a particular nature of work such as large construction activity.

Current priorities for India

In the current context, the real challenge for India is to manage several transitions occurring simultaneously.

First, the structural shift in the domestic economy to higher growth.

Second, the lagged supply response.

Third, supply shock of oil followed by another of primary commodities, influencing inflation expectations.

Fourth, manage the consequences of the global excess liquidity, global imbalances, and sudden re-pricing of risks in international financial markets.

Fifth, the potential for excess volatility in the cross-border capital flows

These challenges are managed involving several trade-offs. While pre-commitment to a set of reforms is useful, some flexibility in policies may be needed to respond to ongoing developments. Such a flexibility to review, rationalise and constantly rebalance the pace and sequencing of various measures impacting financial markets is considered desirable and the financial markets are generally kept informed of these developments. In fact, there are grounds for the financial markets to be comfortable with such flexibilities in policy measures that add to the overall financial stability.

To conclude, there are reasons to believe that these transitions in India will be managed smoothly by public policy, in general, and monetary policy, in particular. Of special interest to this gathering may be the fact that India does not contribute to global imbalances either positively or negatively. The corporate, banking and government balance sheets are not unduly exposed to currency risks. Financial sector, including financial markets, are generally considered to be robust and fairly efficient. There seem to be reasonably good prospects for continuing the current growth momentum in an enabling policy environment of contextual re-emphasis on price stability.