Y V Reddy: India – perspective for growth with stability

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Symposium on Current India at the Institute for Indian Economic Studies, Waseda University,Tokyo, 28 May 2007.

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Professor Sakakibara, Governor Fukui, Ambassador Singh and the distinguished participants,

I am honoured to be invited at the "Symposium on Current India" organised by the Waseda University Institute for Indian Economic Studies. I am grateful to Professor Sakakibara, a globally distinguished economic statesman, for inviting me to be here. It is also a privilege to share a platform with universally respected Governor Fukui.

There are strong complementarities in the economic endowments of India and Japan. For example, these relate to capital surplus, demography, technological specialistion and raw material endowment. We know that Indo-Japan trade and economic relations are moving on to a new trajectory with major new initiatives in Asia.

Several infrastructure projects in India are being considered in joint-partnership with Japan. I hope that during the Symposium, vital issues and areas relevant for the mutual benefit of both countries would be highlighted.

Keeping in view the topic of the Symposium and my *locus standi*, I have chosen to speak on "Perspective for Growth with Stability" in the context of Indian economy.

1. A quarter century of growth with stability (1980-2005)

The Indian economy has been growing at an average growth rate of about 6.0 per cent over a period of 25 years since 1980-81 (India's fiscal year is from 1st April to 31st March).

The important point to note is that not only the growth rate of the Indian economy has been high during this period, but there has been considerable amount of stability also. A remarkable feature of India's growth experience has been its resilience to both global and domestic shocks.

Several hypotheses are given to explain this level of consistency in India's growth rate despite the fact that we faced several exogenous shocks like contagion effect of international financial crises, security tensions, international sanctions, poor rainfall, etc.

The dominance of domestic consumption, contributing on an average to almost two-thirds of the overall demand, has helped in reducing the volatility of GDP. Services sector is dominant and less volatile compared to agriculture and this phenomenon has also been imparting stability to the Indian growth process. The larger share of the services sector growth is currently providing the synergy between services and manufacturing industry, which is enhancing total factor productivity and competitiveness in both. However, agriculture remains the most critical sector for ensuring sustained growth, over the medium term, to benefit large masses of people – especially in rural areas.

2. Recent acceleration of growth and confidence

After growing at around 6 per cent for 25 years, India has entered into what one might call a high-growth phase, with the growth rate averaging 8.6 per cent per annum in the last four years since 2003-04. During this period, the average inflation rate has been contained at about 5 per cent, which has been significantly lower than that of around 8 per cent in the previous three-and-a-half decades. In the last two years, the growth rate has averaged 9.1 per cent with GDP estimated to have grown at 9.2 per cent in 2006-07. For the year 2007-08, the Reserve Bank projects the growth rate in GDP is to be around 8.5 per cent.

During 2006-07, the average headline inflation rate remained at about 5.4 per cent despite some pick up in inflation rate to above 6 per cent in the terminal months of financial year 2006-07. There is some moderation since then and the headline inflation for the week ended May 12, 2007, is 5.27 per cent. For the year 2007-08, the Reserve Bank's policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08. In recognition of India's evolving integration with the global economy and societal

preferences, the resolve, going forward, is to condition policy and expectations for inflation in the range of 4.0–4.5 per cent. This objective would be conducive for maintaining self-accelerating growth over the medium-term.

A welcome development in regard to inflation and growth prospects 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.

A notable recent development is that India is also becoming a major hub for manufacturing and export of manufactured products and some examples of global competitiveness of Indian industry may be in order. Steel production in India is now amongst the lowest-cost production in the world. Pharmaceutical and biotech firms are likewise very competitive internationally. In recent years, we have witnessed the coming of age of the Indian IT multinationals, indigenous players beginning to build noticeable presence in other locations – through cross-border acquisitions, off-shore winning of contracts and organic growth in other low-cost locations. Indian manufacturing firms are acquiring firms abroad to leverage comparative advantage of foreign locations, using synergies between the parent company and the company under acquisition to gain scale economies as well as domain knowledge.

It is a matter of satisfaction to the Reserve Bank of India that the financial sector has acquired greater strength, efficiency and stability. This is the combined effect of increased competition, regulatory measures aligned with international standards, conducive policy environment and motivation amongst the market players, including the banks. The money market has been progressively developed. The Government securities market is deep, liquid, vibrant and well developed in terms of instruments, processes and 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 capitalisation, turnover and systems and processes.

True, the corporate debt market in India is somewhat less developed relative to major financial centres, but has a large potential in the medium term to raise resources particularly for infrastructure projects, housing and for corporate and municipal needs. Supply of institutional funds is likely to be enhanced with ongoing transformation in insurance and pension sectors. The well-developed government securities market, the strong micro-structures and financial infrastructure, the skills of market participants should enable a very rapid and healthy growth of the debt markets in India.

As far as India's external sector is concerned, it 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 24 per cent during the last four years. Sustained growth in export of services and remittances continued to provide buoyancy to the surplus in the invisible account. There was a significant strengthening in the capital account. With the foreign exchange reserves above US$ 200 billion, the reserves currently exceed the country's external debt of about US$ 142.7 billion as at end December 2006, thereby reflecting improved external sector sustainability of the economy.

The current mood in our country on Indian economy is best summed up in the words of our Prime Minister, Dr. Manmohan Singh:

"*We must think big and bold. We must move away from the paradigm of incremental growth to a paradigm of exponential growth and growth into uncharted territory.*"

3. Explorations on economic prospects

There are sound reasons for the optimism expressed in our Prime Minister's statement and the overarching policy challenge at this stage is to manage the transition to a higher-growth path in a sustainable manner by containing inflationary pressures. In this context, I would like to explore here some relevant issues.

(i) Savings-investment: favourable trends

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 an efficient use of capital. Domestic saving rate has also improved from 23.5 per cent to 32.4 per cent during the same period. This was made possible due to improvements in both public sector and private corporate savings. Given the fact that Indian per capita income is increasing rapidly and policy efforts towards financial deepening for achieving a more inclusive growth are underway, savings rate in India could even rise further in the medium to long run. The level of saving rates should help finance the investment needs of the economy especially for development of social and physical infrastructure. As already mentioned in regard to financial sector developments, especially the corporate debt market, we should expect efficient financial intermediation to match the growth in savings, especially long-term contractual savings, through insurance companies and pension funds and meet the growing demands for long-term funds for infrastructure in India.

(ii) Evidence of increasing productivity

Yet another positive factor for India is the trend in productivity. Some of the recent studies relating to India have indicated an increase in total factor productivity (TFP) growth in recent years. For instance, Rodrick and Subramanian, in an IMF working paper of 2004, point out that India seems to have large amount of productivity growth from a relatively modest reforms. A more recent paper by Barry Bosworth, Susan Collins, and Arvind Virmani (2006) confirms this trend. They find that output per worker grew only 1.3 per cent annually during 1960-1980, when GDP growth was also at a low of 3.4 per cent. TFP growth was barely above zero, according to their calculations, indicating that growth in output was almost entirely driven by growth in inputs. In contrast, growth in output per worker nearly tripled to 3.8 per cent during 1980-2004, while TFP increased ten-fold to 2 per cent.

The evidence of an increase in the growth of labour productivity is also available from other studies (Economic Intelligence Unit, 2007). A Study by Tata Services (2003) found that for the all-India manufacturing sector, labour productivity (output per unit of labour) has increased significantly during the post-reform period, compared to the pre-reform period.

(iii) Physical infrastructure: grounds for optimism

Admittedly, a critical constraint to economic growth in India in recent years has been the infrastructure deficit. The Approach Paper to the 11th Five Year Plan has estimated that for accelerating the GDP growth from 7 to 9 per cent, there is a need for accelerating the current level of investment in infrastructure from 4.6 per cent of GDP to 8 per cent during the Plan period. The issue of providing adequate and quality infrastructure has already attracted attention of policy makers at all levels. The Committee on Infrastructure, headed by the honourable Prime Minister, has estimated the investment requirements of the Indian economy during the 11th Five-Year Plan at around US$ 345 billion, i.e., roughly 8 per cent of GDP, every year.

There are several grounds for optimism in regard to overcoming the problems relating to physical infrastructure, provided the framework of public policy, especially regulatory environment, is conducive. First, there is adequate generation of domestic savings while India has also become an attractive destination for foreign capital.. As in the past, over 90 to 95 per cent of investment could be funded by domestic savings. As already mentioned, recent developments in insurance, pension, debt market, fiscal side, etc., add to the prospects of efficient and adequate domestic financing options for infrastructure development. Second, the infrastructure investments in India are basically demand driven and hence, are likely to have a short gestation. Third, there are significant domestic entrepreneurial-, construction-, technological-skill capabilities to execute the projects efficiently and promptly. Fourth, the growth and quality of services sector in India adds to the potential for enhanced productivity in investments in physical infrastructure. Finally, a dynamic mix of public-private and domestic-foreign partnership is already evident in many sectors such as airports.

(iv) Improvements in fiscal balance

It is true that the aggregate stock of public debt of the Centre and States as a percentage of GDP is high, currently at around seventy five per cent. However, there are signs of improvement even after adjusting for recent favourable cyclical factors. The fiscal-management of Central Government is broadly in the direction of achieving the targeted ratio of gross fiscal deficit (GFD) to gross domestic product (GDP) to three per cent and eliminate revenue deficit (RD) by 2008-09. It may be noted that the GFD / GDP and RD / GDP ratios are already budgeted to reduce to 3.3 per cent and 1.5 per cent in 2007-08. In the recent years, there has been a significant improvement in State level finances also.

The GFD of all States declined from 4.7 per cent of GDP in 1999-2000 to 2.7 per cent of GDP in 2006-07, while the RD came down from 2.7 per cent of GDP to 0.1 per cent of GDP. Most States have also enacted fiscal responsibility legislations.

It is also useful to note that there are several unique features of management of public debt in India, which imparts overall stability to macro-economy. First, States have no direct exposure to external debt. Second, almost the whole of public debt is local currency denominated and held almost wholly by residents. Third, public debt, of both Centre and States is actively and prudently managed by the Reserve Bank of India ensuring comfort to financial markets without any undue volatility.. Fourth, the government securities market has developed significantly in recent years in terms of turnover, depth and participants, and significant further improvements are underway. Fifth, stable contractual savings supplement marketable debt in financing deficits. Finally, direct monetary financing of primary issues of debt has been discontinued since April 2006. Hence, the high stock of public debt relative to GDP has not so far been a matter of concern as far as stability is concerned, while it is recognised that long term sustainability would call for a gradual reduction to prudential levels.

(v) Demographic dividend and challenge

India has the world's youngest and fastest growing working-age population. At present, about 36 per cent of Indian population is below 15 years age. It is expected that the average age of the population in India will decline, before it begins to rise after 25 years. In contrast to the rise in the median age of population in the industrialised countries from early 30s to early 40s over the last two decades, the median age in India has increased from 20 in 1980 to 24 in 2005. According to the projections made by the United Nations, the median age in India would cross 30, only by 2025 and would remain around 35 till 2040. In 2020, the average Indian will be only 29 years old, compared with the average age of 37 years in China and the US, 45 in west Europe and 48 in Japan.

While there are some inter-regional differences in demographic features, given the free labour mobility, for the country as a whole, the relatively prolonged favourable demographic transition would have an important bearing on the overall economic growth process.

Given our emphasis on human resource development in terms of producing large number of engineers, technologists, doctors, etc., it is expected that a large and young population of India would have high labour productivity along with lower need for social security and health related expenditures. This is expected to power the growth process of not only India, but would increasingly meet the growing need of other industrialised countries.

The demographic process would, no doubt, create a large and growing labour force. However, the window of opportunity provided by a relatively large and young workforce in India needs a conducive social policy environment for getting realised. In this context, it is recognised that further efforts are needed at accelerated pace to create a quality social infrastructure in terms of education and health which can help the easy and productive absorption of the prospective "youth bulge". Public policy is increasingly aware of the need to give high priority to education and health and also generating employment that is consistent with global competitiveness. In other words, to reap the rewards of demographic dividend, public-policy has a critical role to play.

(vi) Poverty and employment: the litmus tests

The growth story in any developing country is incomplete without assessing its impact on the poverty and employment situation. The number of people living below the poverty line in India has decreased from around 36 per cent in 1993-94 to 22.0 per cent in 2004-05. The average decline in the percentage of people below the poverty line over the period 1993-94 to 2004-05 is 0.74 percentage points per year. India has ranked 126th, in terms of human development index (HDI) according to the UNDP Human Development Report, 2006. The most daunting task for public policy is to ensure that adequate work is found for millions of poor people and in particular to the growing number of young persons.

As per broad results of a recent job survey published in one of the popular magazines, the current high growth phase is not a jobless growth, but now the jobs are created in almost all sectors as compared to the 1990s. According to the report and other anecdotal evidence, the benefits of recent surge in growth rate of GDP are not just restricted to large cities, but people in other urban and semi urban areas are also gaining.

While there is some evidence of reduction in under employment and disguised unemployment in the informal sector and larger work opportunities, the provision of productive employment is of highest priority in India.

5. Explorations on the financial sector

(i) Strong and resilient banking sector – the way ahead

While the broad objectives of the financial sector reforms were to enhance efficiency and productivity, the process of reforms was initiated in a gradual and properly sequenced manner so as to have a reinforcing effect. The approach has been to consistently upgrade the financial sector by adopting the international best practices through a consultative process.

The banking system in India has undergone significant changes during last 16 years. There have been new banks, new instruments, new windows, new opportunities and, along with all this, new challenges. While deregulation has opened up new vistas for banks to augment incomes, it has also entailed greater competition and consequently greater risks. The traditional face of banks as mere financial intermediaries has since altered and risk management has emerged as the defining attribute. Banks have been provided significant operational freedom in their resource allocation using their commercial judgements in a market oriented environment. The capital adequacy ratio has increased to 12.4 per cent for scheduled commercial banks as at end March 2006, which is much above the international norm. Commercial banks' net profits were at 0.9 per cent of total assets during 2004-05 and 2005-06, up from 0.16 per cent in 1995-96. The net non-performing assets declined to 1.3 per cent of net advances during 2005-06 from 2.0 per cent in 2004-05. According to the preliminary financial results available for most of the banks for the year 2006-07, the financial soundness has improved further.

Our banking sector reform has been unique in the world in that it combines a comprehensive reorientation of competition, regulation and ownership in a non-disruptive and cost-effective manner. Indeed our banking reform is a good illustration of the dynamism of the public sector in managing the overhang problems and the pragmatism of public policy in enabling the domestic and foreign private sectors to compete and expand.

The way ahead for the financial sector as whole, given the strong foundations and basic institutional framework, relates to the pace of further deregulation and liberalisation, consistent with the progress of reform in the real and fiscal sectors. The Reserve Bank and the commercial banks have been preparing to implement Basel II. In practice, within the given legal framework, priorities have to be appropriately set ensuring implementation of intended reforms in banking sector in tune with the evolving domestic and external developments.

(ii) Financial markets – efficient and developing

Development of financial markets received a strong impetus from financial sector reforms since the early 1990s. Reforms in financial markets were carefully sequenced ensuring that they were in sync with the real sector. The reforms were also important for developing the environment for effective monetary policy making and monetary transmission mechanisms. As in other areas of reform, a gradual approach was followed in respect of development of financial markets. This has served India well since it helps in continuous rebalancing of the various elements depending on global and domestic developments and thus maximises benefits while minimising costs associated with the process of financial integration. In this approach, the pace and sequencing of financial liberalisation could be tempered keeping in view the degree of comfort in moving forward in a credible way. Gradualism also enables harmonisation with reforms in other sectors of the economy.

A wide range of regulatory and institutional reforms were introduced in a planned manner over a period to improve the efficiency of financial markets. These included development of market micro structure, removal of structural bottlenecks, introduction/ diversification of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions, better regulatory systems, introduction of new technology, improvement in trading infrastructure, clearing and settlement practices and greater transparency. Prudential norms were introduced early in the reform phase, followed by interest rate deregulation and gradual lowering of statutory pre-emptions. These policies were supplemented by strengthening of institutions, encouraging good market practices, rationalised tax structures and enabling legislative and accounting framework.

Going forward, a judicious mix of appropriate policy, strong macro economy and sound and resilient financial system would be necessary as the Indian economy moves up in the ladder from an emerging market economy towards a more mature economy. As development of financial markets is an ongoing process, initiatives to further deepen and widen the various segments of financial markets would have to be continuously pursued. As the economy ascends a higher growth path, with greater opening up and financial integration with the rest of the world, the financial sector development in all its aspects will need further scaling up along with corresponding measures to continue regulatory modernisation and strengthening. Since the overall objective of maintaining price stability in the context of economic growth and financial stability will remain, the effort will be to harmonise the deregulation and liberalisation of financial markets with the domestic developments in real as well as fiscal sectors and global developments in international financial architecture.

(iii) Capital account: calibrated liberalisation

Drawing on the experience of the past decade and a half, India's approach to capital account liberalisation can be summarised as follows: First, capital account liberalisation is treated as a process and not an event. Second, it is recognised that there may be links between the current and capital accounts and hence procedures are in place to avoid capital flows in the guise of current account transactions. Third, capital account liberalisation is kept in tune with other reforms. The extent and timing of capital account liberalisation is properly sequenced with other concomitant developments such as strengthening of banking, fiscal consolidation, market development and integration, trade liberalisation, and the changing domestic and external economic environments. Fourth, the pace and sequencing of liberalisation is responsive to domestic developments, especially in the monetary and financial sectors, and the evolving international financial architecture. As liberalisation advances, the administrative measures are reduced and price-based measures are increased, but the freedom to change the mix and reimpose controls is demonstrably available. Fifth, a hierarchy is established in the sources and types of capital flows. The priority has been to liberalise inflows relative to outflows, but all outflows associated with inflows have been totally freed. Sixth, significant liberalisation on outflows on behalf of individuals, corporates, and mutual funds is underway consistent with significant strengthening of the external sector. Finally, while pursuing the medium-term objective of fuller capital account liberalisation, currently the need for pursuing controls of a prudential nature particularly on financial intermediaries and contextually, more active management of capital account is duly recognised.

Going forward, India plans to continue its carefully calibrated gradualist approach as it enables harmonisation with reforms in other sectors of the economy. The pace of further liberalisation will, however, depend on domestic factors, especially further progress in reforms in real sector, fiscal consolidation, and the evolving financial architecture; and international developments in addition to achievement of certain "concomitants", indicated in the latest Tarapore Committee on the subject.

6. Concluding remarks

Friends, I hope that I have given you a bird's eye view of performance of the Indian economy, in terms of growth and stability. As mentioned, there are challenges, especially in the area of physical infrastructure, agriculture and delivery of essential public services such as education and health. I have also explained that there are some grounds for optimism that we in India are on a path of self-accelerating developmental mode with some inherent and unique strengths. The growth dynamics in India are led by widespread and well-dispersed entrepreneurial talent with a penchant for innovation. It is a business-led growth with large networks of markets both in real economy and financial sector, transiting from emerging to a fully mature status. The growth is led significantly by domestic demand – both consumption and investment. We have remarkable political system stability. India is a country of great diversities, but with incredibly harmonious coexistence of various religions, languages and a unified culture. Hence, personally, I believe that India has inherent strengths, in terms of assimilating constructively, healthy, new and diversified values to fit into the international systems very smoothly and efficiently.

Let me conclude by thanking the organisers again for giving me this opportunity to be with you and mutually benefit from the deliberations.