

Indian Economy in the Global Setting*

RAKESH MOHAN

I am extremely happy to be here in this at 99th Foundation Day Celebration Function of the Indian Merchants' Chamber at Mumbai on September 8, 2005. Indian Merchants Chamber has a long heritage – and I wish them all the best for this year's celebrations and next year's centenary. In this age of globalisation, I thought it would be apposite to share with you an account of India's place in the global economy.

In the recent decade, India along with China has emerged as the engine of global growth. This is well reflected in India's share in world GDP increasing significantly from 4.3 per cent in 1991 to 5.8 per cent in 2004. This period has also been one when India initiated structural reforms which encompassed, *inter alia*, a phased opening up of the Indian economy to the external sector. These structural reforms have strengthened India's external sector and have also imparted a degree of dynamism to the Indian economy. The opening up of the Indian economy has not only allowed it to reap benefits of globalisation but India is also contributing to global growth. Against this backdrop, I discuss India's recent economic growth record in order to draw lessons for it to realise its potential in a globalised world.

RECENT ECONOMIC GROWTH: OVERVIEW AND ISSUES

Economic developments in the recent years indicate a growing resilience of the Indian economy. Illustratively, even as the Indian economy was buffeted by exogenous shocks emanating from a below normal monsoon and record high international oil prices, overall GDP growth was almost 7 per cent during 2004-05. Effective macroeconomic management during the year ensured that India remained one of the fastest growing economies among emerging market economies in an environment of macroeconomic and financial stability. Looking at the post-reform period, real GDP growth has stepped up from

5.8 per cent per annum during the 1980s to 6.2 per cent per annum between 1992-93 and 2004-05. Over the same period, per capita growth has recorded a more impressive increase from 3.4 per cent to 4.3 per cent.

Structural reforms have increased the competitiveness of Indian industry and this is reflected quite vividly in the robust merchandise export growth since 2002-03 exports have grown (in US \$ terms) by more than 20 per cent per annum in each of the last three years. Concomitantly, the services sector contributes more than one-half of GDP, with growing contributions from new impulses of growth such as the information technology, telecommunication and transport sectors and tourism, through a revival of foreign tourist arrivals.

A noteworthy feature of macroeconomic management is the success with maintaining price and financial stability. Inflation has averaged close to five per cent per annum since the second half of the 1990s, significantly lower than that of around seven to eight per cent in the previous three and a half decades. This was possible due to effective monetary management, enabled by reforms in the fiscal-monetary interface. This has had a soothing influence on inflation expectations. Thus, despite poor monsoon conditions, record international crude oil prices and sharp increases in a host of non-oil commodity prices, inflation could be contained at around 5 per cent by the end of fiscal 2004-05, reflecting effective calibrated monetary measures supported by timely supply-side and fiscal measures. Inflation in the current year so far has eased to 3.1 per cent, although it needs to be recognised that the pass-through of international oil prices to domestic oil prices remains incomplete. We may also note that unlike previous oil price rise episodes, international inflation has also been contained this time.

Another notable feature of the post-reform period is improvement in the health of the financial sector. Reforms

* Address by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India at 99th Foundation Day Celebration Function of the Indian Merchants' Chamber on September 8, 2005 at Mumbai. The assistance of Dr. Narendra Jadhav and Shri Muneesh Kapur in preparation of this address is gratefully acknowledged.

in the financial sector introduced since the early 1990s have had a major impact on the overall efficiency and stability of the banking system, reflected in improvements in capital adequacy ratios and strengthening of the balance sheets. Furthermore, Indian banks have done a remarkable job in containment of NPLs considering the overhang issues and overall difficult environment. Net NPAs have now fallen to just two per cent of net advances.

The external sector continues to be robust. Despite sharp increase in oil as well as non-oil imports, India's balance of payments has recorded large and persistent surpluses, with foreign exchange reserves at around US \$ 144 billion. Increased earnings from exports of services and remittances coupled with enhanced foreign investment inflows have provided strength to the external sector.

In brief, the Indian economy has exhibited a strong performance since the early 1990s in an environment of macroeconomic and financial stability—higher GDP growth, lower inflation, a resilient external sector and a strong financial sector. All this happened during the 1990s, which was otherwise a turbulent decade in terms of financial instability in many other countries. Nonetheless, it is widely agreed that the growth of the Indian economy remains well-below its potential. Real GDP growth in the first three years (2002-03 to 2004-05) of the Tenth Plan period has averaged 6.5 per cent, lower than the Tenth Five Year Plan (2002-2007) target of eight per cent per annum. While the economy is doing well in many areas and these gains need to be consolidated, there are also important weaknesses, which, if not corrected could undermine even the potential performance level. In this context, it is interesting to note that the recent years (2001-02 to 2003-04) have seen India recording surpluses in the current account, *i.e.*, we have not been able to find investment avenues to deploy our domestic savings. It is, therefore, important that impediments to investment be removed so that domestic savings can be deployed at home. Of course, to realise the growth potential of 8-9 per cent of the Indian economy, domestic savings will have also to record commensurate increases. Reforms would have to be further intensified in the agricultural sector to promote flexibility in factor markets in bankruptcy and exit procedures, in fiscal consolidation and in physical and social infrastructure sectors to accelerate investment. I will address some of these issues next.

Although the poverty ratio has declined since the onset of the reforms process, the number of people below

the poverty line still remains high, with wide variations across states. Between 1977-78 and 1999-2000, the proportion of people living below the poverty line fell from 51.3 per cent to 26.1 per cent; over the same period, the absolute number of poor people fell from about 330 million to about 260 million, a number that is still sizable. In 2001-03, for instance, India's per capita income was equivalent to only 9 per cent of the global average and 2 per cent of the per capita income of the high income countries.

With more than half of the people still dependent on agriculture, a key area of concern is that agricultural growth remains low and continues to be monsoon-dependent. Growth in the agricultural and allied sectors has decelerated from 3.2 per cent per annum during 1980-96 to 1.9 per cent subsequently. Per capita agricultural GDP has shown no significant upward trend after 1996-97. The slowdown is wide-spread across crops and reflects a broad based deceleration in productivity growth. The deceleration in output coincided with a downturn in world prices, and this has impacted domestic farm prices more than in earlier decades because of greater openness. The consequence has been that farm incomes became more variable and decelerated more than output in many cases.

A related cause of concern, given that 57 per cent of population is still agriculture dependent, is that the role of agriculture in providing additional employment opportunities was virtually zero during the 1990s. Employment in agriculture remained virtually unchanged at about 190 million people during the 1990s. Concomitantly, annual employment growth for the economy, as a whole, decelerated from two per cent during the 1980s to only 1.1 per cent in the latter half of the 1990s. With employment growth trailing the additions to the labour force, the unemployment rate for the economy as a whole is estimated to have increased from 8.87 per cent in 2001-02 to 9.11 per cent in 2004-05, a proportion that is far too high for a country like ours. The generation of productive employment is, therefore, a key issue that needs to be addressed on a continuous basis.

The slowdown in the agricultural sector reflects subdued public investment in agriculture and inadequate crop diversification. A step-up in public investment in rural infrastructural areas such as irrigation, rural electrification and rural roads will become possible through reduction in and better targeting of subsidies that would then enable greater public investment for promoting growth. Efforts are also needed to diversify the cropping

pattern to non-traditional activities in line with the changing agricultural demand pattern and making use of recent advances in bio-technology. The process of diversification calls for micro-level planning with emphasis on crop specific inputs, creating proper marketing infrastructure, cold storage, transportation facilities and supportive policies. There is a need for value addition in agricultural products through processing, packaging, and supply chain management so that farm incomes expand, employment is generated and rural poverty is alleviated. Other initiatives to increase agricultural production could cover aspects such as better availability of commodity derivatives to minimise the impact of price uncertainty; reducing monsoon-dependency through schemes like water harvesting; and, further augmenting the flow of credit to the rural sector. Diversification of agriculture would also provide stable additional avenues of employment generation in the rural sector and enable these sectors to emerge as the main source of growth and employment in rural areas. All these measures will promote competitiveness of the agricultural sector, which is so necessary in the current global context.

As regards social sector indicators, notwithstanding some progress in regard to education and health, India is still far behind its East Asian neighbours. Our social indicators are lower even in comparison with the levels achieved by these countries twenty five years ago, when they first began to grow rapidly. The social indicators also show disturbing gender gaps, large rural-urban differences and wide variation across states. Although the literacy rate has improved encouragingly from 52.2 per cent in 1991 to 64.8 per cent in 2001 and the overall number of illiterates in the country declined from 329 million in 1991 to 306 million in 2001, there are at least seven major States with more than 15 million illiterates each, accounting for nearly two-third of total illiterates in the country. Concomitantly, given India's comparative advantage in services, it is important that the quality of secondary and higher education in the country is improved so that adequate skills are developed to realise the benefits of the knowledge economy. As regards health, the combined government (Centre plus States) expenditure on health as a percentage of GDP has stagnated at around one per cent of GDP over the last decade and a half. Total public expenditure on health in India remains even lower than many other developing countries such as Brazil (3.4 per cent), Thailand (2.1 per cent), Sri Lanka (1.8 per cent), China (1.9 per cent) and Malaysia (1.5 per

cent). Low public expenditure in India is to some extent compensated by private expenditure which at 4.0 per cent of GDP is comparatively higher than all of these countries except Brazil (4.9 per cent). However, low public expenditure is a cause for concern for the vast majority of the population and primary health care remains of poor quality, unavailable and inaccessible. The infant mortality rate in India is almost double that of China (63 in India versus 37 in China) while the maternal mortality rate at 407 is manifold as compared to China's 56. Hospital beds (per 1000 population) at 0.7 for India are less than one-half of other developing economies such as China (2.4), Thailand (2.0) and Malaysia (2.0). A significant improvement in social indicators is necessary if we want to create the pre-condition for a general improvement in welfare of our population and for genuine equality of opportunity.

Turning to the industrial sector, reforms which encompassed removal of industrial licensing, de-reservation, substantial opening of foreign direct investment and trade liberalisation have imparted a competitive edge to Indian industry. This is reflected in a resurgence of activity in the manufacturing sector in the past two years, and the present phase appears to be sustainable, in contrast to the exuberance – which turned out to be temporary - reflected in high growth in investment and production in industry during 1993-94 to 1996-97. For industrial activity to get entrenched and gather momentum, efficiency in supply of infrastructural inputs will need a large impetus. The subdued performance of the infrastructure sector in the recent months is an issue of concern, given the sector's strong forward and backward linkages in the economy. The increasing demand-supply gap in the availability of power is becoming the most critical issue for the future of India's economic development. In the recent period, shortage of coal and gas has emerged as a serious constraint on power generation with the supply of both fuels falling far short of demand. In this context, given the fact that the Indian economy is among the more inefficient users of energy, the highest priority needs to be given for energy-saving measures, which could include appropriate pricing policies and incentives to invest.

With growing urbanisation, issues related to urban infrastructure have come to the forefront. At present, investment in urban infrastructure is hampered by the fact that local governments are not yet creditworthy and urban infrastructure projects are, therefore, not found to

be commercially viable. Strengthened planning and better coordination between various agencies entrusted with maintenance of urban infrastructure would have a positive impact on the overall productivity of economic activity in cities. Given the fact that there is a heavy concentration of economic activity in large cities, weak infrastructural facilities impede the growth of large cities and of overall economic productivity. It is, therefore, of the utmost importance that the quality of urban infrastructure in the large cities is improved significantly so as to maintain and accelerate the momentum of economic growth and productivity enhancement. For urbanising economies like India to replicate the experience of developed countries in the provision of urban infrastructure, it is essential that all aspects of city management, including the fostering of a professional workforce, are strengthened.

The maintenance of vibrant growth in the manufacturing sector will depend crucially on the expansion of small and medium enterprises that then become significant players in the future. For this potential to be realised, there is a need to increase credit availability to this sector at reasonable costs. Banking institutions need to improve their credit assessment capabilities with regard to small-scale enterprises and small-scale must not be equated with high risk. Recent initiatives of the government and the Reserve Bank, such as the new legislation aimed at developing credit information bureaus will help to reduce information and transaction costs that should then lead to lower cost of credit to the SSI sector. Empirical evidence shows that wider availability of credit histories greatly expands the flow of credit as potential borrowers are no longer tied to their local lenders.

The services sector has emerged as the largest contributor to growth in the country. Advances in information technology, liberalisation of the telecommunications sector and availability of skilled labour have permitted India to reap advantages through the globalisation of some services. The initial impetus provided by exports of software and services has now got additional support from the exponential growth of the IT-enabled sector (ITES). According to the National Association of Software and Service Companies (NASSCOM), India's software and service exports recorded a strong growth of 34 per cent in 2004-05. The software sector [including ITES-Business Process Outsourcing (BPO)] now employs more than one million people, having recorded a compounded annual growth

of nearly 30 per cent in employment during the period 1999-2005. The software sector also provides indirect employment to 2.5 million people. These data bring forth the growing role of the software sector, but at the same time, they suggest that for this order of growth rates to be maintained in the future, investment in social infrastructure – especially, education - needs to stepped-up. In this context, it is necessary that public expenditure on education should reverse its declining trend. Total expenditure by the State Governments on education is budgeted to decline from 2.5 per cent of GDP in 2003-04 to 2.3 per cent in 2005-06. Moreover, given the demographic profile, the demand for education is slated to increase further. Accordingly, the improvement in State finances will enable the States to increase their expenditure on education and other social services and thereby improve the quality of overall social infrastructure so that India can realise its potential.

It is now well-recognised that monetary policy can contribute to long-run growth by maintaining low and stable inflation. International experience indicates that a prudent fiscal policy remains the single largest prerequisite for monetary stability. In India, reforms in the monetary-fiscal interface during the 1990s have been a key factor that imparted greater flexibility to monetary policy. These reforms have taken a significant step forward with the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 by the Centre. With the Centre's GFD/GDP ratio at 4.1 per cent in 2004-05 (provisional accounts), the FRBM target of 3.0 per cent by 2008-09 appears to be within striking distance. However, with revenue deficit at 2.7 per cent in 2004-05, the elimination of the revenue deficit by 2008-09 will prove to be more difficult. Achieving this target requires continued focused action on containing expenditures, increase in tax revenues and reduction in tax exemptions. Revenue augmentation would depend critically on improvement in the tax/GDP ratio as non-tax revenue is set to decline in the coming years. With the acceleration in overall economic growth that is being observed currently, renewed efforts on tax compliance should yield beneficial results. Achievement of the FRBM target of revenue deficit at zero per cent of GDP will free up resources for public investment which will also crowd-in private investment. Overall, despite the recent improvements in the fiscal position of the Central Government the effort in achieving fiscal consolidation will have to continue.

International crude oil prices are touching a record high. In previous episodes of such high oil prices, India often faced balance of payments crisis, low growth and high inflation. In the current period, the economy has been able to absorb the oil shock relatively comfortably so far. However, in case international oil prices continue to remain at the existing elevated levels, they could have a negative influence on growth prospects internationally. It is important to note that oil intensity – oil consumption per unit of output – in India has increased since the early 1970s in contrast to the behaviour of major economies such as the Euro area, the US and Japan. Although oil intensity in India is still lower than that of advanced economies, there is scope for adopting measures to enhance efficiency of oil use in the economy. Energy conservation measures in the backdrop of high and volatile international crude oil prices could help the Indian economy to weather the adverse consequences with relatively lower output losses. In this context, there is a need for policies that permit flexibility in domestic oil prices that respond to the ups and downs in international prices, *albeit* with some mechanism that cushions the impact on the common man. This will also enable more efficient use of oil in the economy, especially in view of the fact that the rise in international oil prices appears to have a large permanent component.

Given the volatility in the inflation rate during 2004-05, there is a need to consolidate the gains obtained in recent years from reining in inflationary expectations. While sustained efforts over time have helped to build confidence in price stability, inflationary expectations can turn adverse in a relatively short time if noticeable adverse movements in prices take place. Credible commitment of policy to fight inflation is critical to stop translation of higher oil prices into wage-price spirals. In addition, the international prices of non-oil primary commodities may continue to remain firm. On the domestic front, the manoeuvrability on oil prices is getting limited and corporates have a higher probability of gaining their pricing power with a better industrial outlook. The pricing pressure, if it were to occur from the supply side, could get complicated by continuing overhang of excess domestic liquidity. While the economy has the resilience to withstand supply shocks, the upside risks do exist. As such, the inflationary situation, both international and

domestic, needs to be watched closely to persevere in maintaining inflation expectations and any complacency on this count could have adverse consequences for both stability and growth.

GLOBAL ECONOMIC INTEGRATION

With the growing external openness of the Indian economy, and given its pace of expansion and size, the debate in the recent period has widened. While, earlier the focus was on the contours of public policy in the context of increasing global economic integration, discussions nowadays have also centred on the challenges likely to be faced by the global economy on account of progressively increasing global integration of the Indian economy. These issues are addressed next.

Globalisation has several dimensions arising out of enhanced connectivity among people across national borders. In particular, economic integration occurs through three channels, *viz.*, movement of people, of goods and, of finance or capital (Reddy, 2004)¹. In managing the process of economic integration, developing countries face challenges from a world order that is particularly burdensome on them. Accumulated international experience in this regard favours a well-managed and appropriate integration into the global process, supported by effective – but not necessarily intrusive or extensive – interventions by governments in order to minimise adverse consequences, especially on the poor, the vulnerable and the underprivileged sections of the society.

Against this backdrop, external sector policies designed to open up the Indian economy progressively, as observed earlier, formed an integral part of the strategy for structural reforms. In this context, the Report of the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan, 1993) recommended improvement in exports, both merchandise and invisibles; modulation of import demand on the basis of the availability of current receipts to ensure a level of current account deficit consistent with normal capital flows; enhancement of non-debt creating flows to limit the debt service burden; adoption of market-determined exchange rate; building up foreign exchange reserves to avoid liquidity crises and elimination of the dependence on short-term debt. These policies have been successful in

¹ “India and the Global Economy”, Address at the Lal Bahadur Shastri National Academy of Administration, Mussorie on July 17, 2004.

strengthening India's external sector by enhancing the country's resilience to a series of external and domestic shocks have imparted stability of the Indian economy.

Various reforms in the trade policy regime have unlocked entrepreneurial energies, stepped up productivity gains and improved competitiveness and access to overseas markets. India's merchandise exports have been rising at a rate of over 20 per cent per annum, in US dollar terms, during 2002-05. As a result, the secular decline in India's share in world exports from two per cent in 1950 to 0.5 per cent in the 1980s has been reversed. This share began rising in the 1990s and is currently at 0.8 per cent. These positive developments in the external sector provide the environment of pursuing a further rationalisation of tariffs with a view towards moving to a single, uniform rate on imports, say 10 per cent, and to simplify all customs procedures strictly in line with best global practices. This should help to improve competition, exports and domestic consumers. The current external environment including the level of the foreign exchange reserves enables such a move to be made with little or no downside risks.

While the recent trend in imports may continue to persist in the face of high and volatile crude prices and the large increase in domestic demand, an intrinsic link between merchandise imports and exports has emerged and become entrenched. The large expansion in imports is also spurring vigorous export growth. Given the recent experience, especially the fact that workers remittances seem to have acquired a semi-permanent, if not permanent, character, the current level of the trade deficit appears to be manageable at this stage and appears to be consistent with India's growth aspirations.

In regard to capital account, the series of financial crises in a number of emerging economies during the 1990s highlighted the adverse consequences of unfettered capital account liberalisation. In this context, India's cautious approach to capital account liberalisation - treating it as a process rather than a single event and calibrating the pace of capital account liberalisation with underlying macroeconomic developments, the state of readiness of the domestic financial system and the dynamics of international financial markets - has served the country well and is now well accepted even internationally. India's policy of managing the capital

account with preference for non-debt flows and de-emphasis on short-term debt flows, coupled with adequate foreign exchange reserves have minimised contagion that could have arisen from financial crises elsewhere. The substitution of debt by non-debt flows also gives room for manoeuvre since debt levels, particularly, external commercial borrowings, have been moderate and can be raised in the event of a sustained pick up in the demand for external resources.

As regards the future course and pace of financial liberalisation in the country, it is worth emphasising a key distinction between trade liberalisation and financial liberalisation. Unlike in the case of trade integration, where benefits to all countries are demonstrable, in case of financial integration, a "threshold" in terms of preparedness and resilience of the economy is important for a country to get full benefits. A judgmental view needs to be taken whether and when a country has reached the "threshold" and the financial integration should be approached cautiously, preferably within the framework of a plausible roadmap that is drawn up by embodying the country-specific context and institutional features. It is, therefore, essential to take into account the risks associated with financial globalisation while resetting an accelerated pace of a gradualist approach (Reddy, 2005)².

As noted earlier, not only do global developments influence India, but the growing size of India also has potential implications for the global economy which would have also to take in to account the evolving demographic dynamics in countries such as India. Over the next half-century, the population of the world will age faster than during the past half-century as fertility rates decline and life expectancy rises. In Europe, the demographic profile is already tilted towards the higher age group and by 2050, this is projected to accelerate. Projections suggest a turning point between 2010 and 2030 when the European Union, North America and Japan will experience a substantial decline in savings rates relative to investment which may be reflected in large current account deficits. Most of the high performers of East Asia and China are in the second stage of the demographic cycle. Elderly dependency is expected to double in these countries by 2025. Their working age populations will increase modestly first and then shrink. These projections suggest that East Asia could

² "Overcoming Challenges in a Globalising Economy: Managing India's External Sector", Address at the India Programme of the Foreign Policy Centre, London, June 23, 2005.

increasingly become an important supplier of global savings up to 2025; however, rapid population ageing thereafter would reinforce rather than mitigate the inexorable decline of global savings. India is entering the second stage of demographic cycle and over the next half-century, a significant increase in both savings rate and share of working age population is expected. The share of the labour force in population in India is expected to overtake the rest of Asia, including China, by 2030.³ Looking ahead, the rest of the world may increasingly rely on China and India for supplies of both labour and capital and this could significantly influence the evolution of the global economy. It is evident that China and India will have to give high priority to generating employment and both are poised for substantial increases in productivity.

The global economy will have to contend with the implications of these developments on prices, exchange rates, wages and structures of employment in industrialised countries. For India to reap benefits from the evolving global demographic changes, sound public policies are an important pre-requisite. In particular, the quality of labour force (in terms of relevant skills which need to be sustained, reoriented and upgraded in a globally competitive era) and the physical health of the workforce become crucial.

The envisaged large scale shift of labour from agriculture to non-agricultural sectors will need institutional arrangements, in the public as well as private sectors, for imparting and upgrading skill. Concomitantly, this large scale redeployment of labour further strengthens the case for an immediate improvement in urban infrastructure and supply-led approaches appear to be in order, rather than waiting for the demand to be generated. The envisaged improvement required in social and urban infrastructure would call for a step-up in the country's investment rate which will, in turn, depend largely upon an increase in domestic savings rate supplemented to some extent by foreign savings, especially direct investment.

Ongoing reforms in the Indian economy supported by the progressive liberalisation of norms relating to joint ventures abroad by the Indian corporates have enabled many of these entities to attain a global presence in all sectors. This process is expected to gather momentum in the coming years. In brief, as Governor Reddy has remarked elsewhere, our global integration has to be a two way process, encompassing movement of people with some caveats, trade in a free and equitable manner and financial integration on a specially sequenced basis.

CONCLUDING OBSERVATIONS

The structural reforms initiated in the early 1990s coupled with a cautious and calibrated approach to external sector liberalisation has led to a step-up in economic growth and India has emerged as one of the fastest growing economies of the world. Notably, this growth has been achieved in an environment of monetary and financial stability, even as there was a series of exogenous shocks, both domestic and foreign, that hit the Indian economy in the period since the latter half of the 1990s. Looking ahead, the evolving demographic profile in favour of younger population suggests that the growth prospects of the Indian economy remain strong, provided their potential is effectively utilised. At the same time, a lot needs to be done to improve the quality of life. While the proportion of the poor in total population has come down, the absolute number of poor people remains high. India's rank in terms of human development index and gender development index continues to be low compared to many developing countries. There is a need for linking growth with development and fill the gap between macroeconomic performance and social sector development. In this regard, globalisation throws both opportunities and challenges for benefit of societies. Opportunities offered by forces of globalisation offer India scope to improve the quality of life of its people, provided appropriate policies are put in place.

³ This is discussed in detail in my paper, "Fiscal Challenges of Population Ageing : The Asian Experience", presented at the Symposium on "Global Demographic Change: Economic Impact and Policy Challenges", Sponsored by the Federal Reserve Bank of Kansas City, in Jackson Hole, Wyoming, August 26-28, 2004.