

# Indian Economy: Looking Ahead

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I have distributed a set of slides on the Indian economy for your reference. I would like to share my insights with you on where the economy is heading. Let me begin by highlighting four major features of India's recent economic performance.

## 1. Upward Growth Path

The Indian economy has been on an upward growth path. In the fiscal year just ended in March 2007, growth of GDP in real terms was 9.4 per cent. The average growth rate over the last two years was 9.2 per cent and over the last four years 8.6 per cent. In the Tenth Five Year Plan period from 2002-03 to 2006-07, real GDP grew at 7.6 per cent per annum. While being lower than the target growth rate of 8 per cent per annum, (mainly because of the poor growth rate in the first year of the Plan), this growth was higher than in any earlier Five Year Plan.

The growth rates of 8½ per cent to 9½ per cent per annum observed in the most recent years have to be seen against the background of a slow and stagnant growth rate of 3½ per cent per annum over the three decades from 1950 to 1980 and a significantly improved growth performance of 5.8 per cent per annum during the two decades from 1980 to 2000.

With population growth of close to 2 per cent per annum, the period from 1950 to 1980 saw per capita income increase at the rate of 1.5 per cent per annum. By contrast, the most recent years have seen per capita income increasing at 7½ to 8 per cent per annum as population growth has declined to 1.5 per cent.

## 2. Poverty declines but challenge remains

The percentage of population in poverty (officially defined as consuming below a certain level) declined from around 50 per cent in 1980 to 28 per cent in 2004-05. An alternative estimate using slightly different sampling methodology suggests that poverty declined from

26 per cent in 1999-00 to 22 per cent in 2004-05. Even at 28 per cent, close to 300 million people remain below the poverty line. In any case, the estimate is based on a narrow definition of poverty rather than a multidimensional definition which incorporates social development indicators of health and education. India's record on social development has been poor. To sum up, while India's economic performance is showing strong improvement, the challenge of alleviating poverty remains large.

### **3. Private sector is the driving force**

The acceleration in growth in the past five years or so is largely driven by the private sector. We are not only reaching the South-East Asian levels of saving (32.4 per cent) and investment (33.8 per cent) rates but the private sector has played a major role in generating these savings and investment. The rate of private investment in 2005-06 was 26.4 per cent, up from 15 per cent in 1996-97. Over the same period, the rate of public investment increased marginally from 7 per cent to 7.4 per cent.

Gradual market orientation of the heavily regulated and highly protected economy of India began in the mid-1980s. More wide-ranging economic reforms with special emphasis on opening up the economy to foreign trade and investment and attempts to restore macro-economic balance (which had deteriorated in the 1980s) began in 1991.

In the earlier phase of reforms, growth was driven by the services sector, particularly IT services. More recently, the manufacturing sector has also been contributing to the dynamism of growth. The agricultural sector has not shared in the acceleration of growth. I will say more on this later.

Pharmaceuticals and auto-components have been two internationally competitive sectors which have shown rapid growth. Of late, textiles and steel are also showing dynamism although in recent months the appreciation of the exchange rate is hurting textile exports. A process of restructuring of the manufacturing sector has been taking place in a slow and steady manner. With greater domestic deregulation, Indian industry has been able to find flexible ways around the rigid labor laws to cut costs and compete.

In the year just ended, foreign direct investment was \$15 billion, almost three times higher than in the preceding year. Retained earnings provided another \$2.7 billion of investment in the same year. More and more manufacturing units in India are developing a global vision.

Indian companies made global deals worth \$23 billion in 2006. The pace has escalated so much that in the first quarter of 2007 alone global deals worth \$23 billion were made.

#### **4. Reforms were steered forward within a robust democratic regime**

A very important feature of India's economic reforms is that they were steered forward by four different democratically elected governments at the Centre and numerous other governments at the state level which represented different political parties or their combinations. The policy changes were debated in a noisy atmosphere of an open and vibrant media and pursued with active involvement of the civil society. China still has to face this music. In India, a robust democratic regime has ensured that slowly and surely the mindset has moved away from controls towards competition – domestic as well as international.

Let me now turn to the challenges that have to be overcome if the high growth is to be sustained.

#### ***Infrastructure***

The inadequacy and poor quality of infrastructure has been known for some time to be a major challenge for sustaining growth rates of 7 to 8 per cent for the Indian economy. The acceleration in the growth rate to 8½ to 9½ per cent in recent years has heightened these concerns, but the progress on infrastructure reforms as well as outcomes has been mixed. The new paradigm for infrastructure development is that of public private partnership based on model concession agreements emphasising accountability and transparency. While there has been a sea change in telecommunications and significant reforms have been undertaken in the area of airports, ports and civil aviation, and more recently in roads and railways, there is a real problem with electric power.

The telecommunication sector in India has been revolutionised and is today a powerful symbol of what economic reforms can achieve for the common man. The entry of private operators has generated competitive conditions in which the incumbent public sector and the new private sector entities have been able to provide better and cheaper telephone facilities to the consumers making use of the mobile technology. The number of mobile phone subscribers has reached 200 million in India although it is still much smaller than the comparable figure of 500 million in China. In the road sector, some major initiatives of the NDA government have been continued with enthusiasm by the current UPA government at the Centre and the impact is beginning to show. The Golden Quadrilateral linking the four

major metros of the country through highways has been completed. This has been followed by a series of initiatives on road networks and also six-laning of the roads on the Golden Quadrilateral. Railways long considered to be a core problem area of infrastructure have in recent years shown a remarkable improvement. New investment has been directed in strategic areas to improve efficiency. Thus, investment in a dedicated freight corridor is designed to facilitate efficient freight movement within the country. There has also been privatisation of containers which has elicited enthusiastic response from the private sector. In ports as well as airports there has been significant investment within the framework of public private partnership. The airline sector has been opened up for private participation and the response has been phenomenal.

Reforms have been the weakest and the slowest in the electricity sector. While generation, transmission and distribution have been separated and independent regulators have been put in place, major problems with respect to pricing, operational efficiency, poor collection of bills and theft of electricity still remain. Only 1/3<sup>rd</sup> of the State Electricity Boards now make profits; others break even. Subsidies on power use have not been withdrawn but are merely being funded through state budgets. The Electricity Act of 2003 had spelt out a scenario for reforms for the state governments but progress has been slow.

### ***Agriculture***

This sector has not shared in the resurgence of growth in India. After 1996-97, growth was an annual average of 1% up to 2000-01 and 2.5% from 2001-02 to 2006-07. Problems in Indian agriculture are either related to stagnant productivity levels requiring heavy doses of research and improved practices of water management and cultivation, etc., or those that are directly the result of government policy design, e.g., spiralling input subsidies for agriculture which have eaten into government's capacity for public investment, inefficient marketing systems, and a highly inefficient public distribution system at subsidised prices for consumers. In times of agricultural shortages in recent months policies have also resorted to knee-jerk reactions such as export bans (as in the case of pulses) and a ban on future trading (as in the case of wheat).

Indian agriculture today faces a range of second generation challenges which need to be addressed if India has to usher in a second Green Revolution. The first set of challenges relates to crop diversification away from food grains. In this context, experiments with BT cotton have been important in an environment dominated by risk and apprehension. Output

of cotton doubled between 2003 and 2007 as average yields increased by about two-thirds largely because of lower rates of pest infestation with the use of BT cotton. In 2006, 2 million small farmers planted an average of 1.6 hectares of BT cotton.

More generally, a move towards diversification into fruits, vegetables and floriculture requires adoption of scientific modes of farming and investment in logistics. It also inevitably implies greater risk than producing food grains for assured markets at prices determined by the government. Research in high value crops and its application in farms through innovative institutional mechanisms such as contract farming need to be encouraged. Mechanisms for crop insurance also have to be devised. Investment in logistics, cold chain and other marketing infrastructure is also necessary to increase the incentive for producing high value crops. The biggest revolution in the Indian rural sector will come from the revolution in retail trading which is on its way. Companies such as Reliance and ITC are already in the market, while Bharati-Walmart is forging an alliance to bring more competition in the organised retail sector.

A second set of challenges relates to the availability of water for Indian agriculture. An inadequate and ineffectively functioning irrigation infrastructure and a declining water table call for policies that encourage conservation of water and investments in watershed management. Correct pricing of water is crucial as is a policy which moves away from giving free electricity to farmers because the latter only encourages excessive use of water for farming.

While agriculture cannot be the engine for growth in the years to come, boosting agricultural growth and fostering linkages with the industrial and services sectors is crucial not only for raising the farmers' returns on high value agriculture but also for the sustainability of the growth process.

### ***Human Capital***

Increasingly, skill shortages are emerging as a major challenge to sustaining the high growth rates of the manufacturing and services sectors. We often hear of the demographic dividend in that 50% of India's population today is of working age. Also, unlike what is the case in major economies such as China, Brazil, USA and Japan, this proportion is projected to continue to increase until 2035. It is also true that India today has the youngest labour force in the world. This has implications for increases not only in the labour force but also in the

saving rate and in the pace of urbanisation. However, this young labour force has to be equipped with a skill set which is in demand as the high growth rate continues and accelerates. The challenge is to provide high quality education as well as adequate opportunities for productive employment.

### ***Macro-economic Management***

Since 1991 an important area of economic reforms has been that of restoring macro-economic balance through fiscal policy as well as financial sector reforms. Tax reforms have been pursued with vigour, the latest achievement in cooperative fiscal federalism being the successful introduction of VAT by the states. Encouraged by the tax buoyancy that resulted from VAT, the government has declared its intention to introduce GST on all goods and services at both—centre and states—levels of government by April 2010. The central government and the empowered committee of state finance ministers that designed the VAT with some handholding by the centre have now set up a working group to prepare the GST road map. Though service tax was introduced by the central government in some sectors which is eligible for tax credit, the entire mix of goods and services will be covered under an overarching structure under the GST. On the expenditure side, reforms have been slow as many wasteful schemes continue. There has been a welcome reallocation of government spending towards education and health. However, increased spending on these sectors has not been accompanied by a major overhaul of the delivery mechanisms for these services.

The Fiscal Responsibility and Budget Management Act (FRBM) of 2003 has put restraints on the Government of India for capping its fiscal deficit, and some state governments have followed up with similar Acts to bring about discipline in their finances. This has clearly helped both central and state governments to bring down their fiscal deficits, and this has shown up most recently in an impressive increase in the savings rate, with a changing composition in its structure, with improvements in the non-household component of savings. The Government of India has also made a commitment to set up an independent debt management office in the Budget of 2007-08. Reforms on the fiscal front have been combined with financial sector reforms which facilitate the gradual opening of the Indian capital market to capital inflows and outflows. However, a substantial degree of capital controls persist and public sector banks which still have a position of dominance in the banking sector have been very slow to reform.

As the Indian economy continues on the path of integration with the world economy, monetary policy will face new challenges. The Reserve Bank of India is learning by doing that macro management in an open economy is a delicate business of minding inflation as well as the exchange rate, while supporting the growth momentum in the economy. For example, in recent months strong capital inflows were putting pressure on the exchange rate to appreciate. The Reserve Bank of India tried to intervene by buying foreign exchange to ward off the pressure on the exchange rate by injecting Indian rupees into the system. This in turn generated inflationary pressure in the economy. It was when the exchange rate was allowed to appreciate that inflation was brought under control. It is time perhaps for the Reserve Bank to consider whether inflation targeting should not comprise the major effort in its brief, as has been the case in many modernising economies. The loosening of capital controls, modernising the domestic financial system and sophisticated use of monetary policy will have to be combined judiciously as India moves up the growth path while opening up to world markets.