Fedbank Hormis Memorial Foundation

The 12th Commemorative Lecture

The Indian Economy - Prospects and Constraints

by

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It gives me great pleasure to be in your midst this evening and to deliver the Hormis Memorial Lecture for this year. The growth and development of Federal Bank is a testimony to the vision and hard work of Mr. Hormis. Federal Bank today rests on the solid foundation laid by him. Mr. Hormis recognized even in those early days the need for banking to function with a social motivation. We need a banking system that is efficient, viable and socially responsible. The continued success of Federal Bank will be the best tribute that you can pay to the memory of Mr. Hormis.

A review of the economy in the recent period throws up several interesting insights. Economic growth has averaged 7.3 per cent per annum over the last decade. Our external payments situation has remained comfortable, even though the current account deficit has started widening in the last two years. Foreign exchange reserves are robust. However, one disturbing element is the persistence of inflation in recent years. The other concern is the recent declining trend in industrial production.

There are many challenges on the way forward. We need to sustain the present rate of growth, if not accelerate it to higher levels. We need to translate growth into poverty reduction. In other words, we need to generate poverty reducing growth i.e. growth to which the poor contribute and from which the poor benefit. We need to expand employment opportunities and improve productivity across all sectors of the economy. We need to narrow economic disparities across and within states without compromising on efficiency. We need to improve on social indicators too; India still ranks a low 119th in the UNDP's Human Development Index in the bottom third of the league of nations. The agenda for achieving growth and poverty reduction is formidable requiring as it does focus not only on identifying priority areas for action but also on effective and efficient implementation of the policy agenda.

The year 1991 is a landmark in the post-independent economic history of India. The country faced a severe economic crisis, triggered in part by a serious balance of payments situation. The crisis was converted into an opportunity to effect some fundamental changes in the content and approach to economic policy.

There is a common thread running through all the measures introduced since July 1991. The objective is simple and that is to improve the efficiency of the system. The regulatory mechanism involving multitudes of controls had fragmented capacity and reduced competition even in the private sector. The thrust of the new economic policy is towards creating a more competitive environment in the economy as a means to improving the productivity and efficiency of the system. This is to be achieved by removing the barriers to entry and the restrictions on growth of firms. While the industrial policy seeks to bring about a greater competitive environment domestically, the trade policy seeks to improve international competitiveness subject to the protection offered by tariffs which are coming down. The private sector is being given a larger space to operate in as some of the areas earlier reserved exclusively for the public sector are also now allowed to the private sector. In these areas, the public sector will have to compete with the private sector, even though the public sector may continue to play a dominant role. What is sought to be achieved is an improvement in the functioning of the various entities whether they are in the private or public sector by injecting an element of competition. There is, however, nothing in the new economic policy which takes away the role of the State or the public sector in the system. The New Economic Policy of India has not necessarily diminished the role of state; it has only redefined it, expanding it in some areas and reducing in some others. As it has been said, somewhat paradoxically 'more market' does not mean 'less Government', but only 'different Government'.

That the content and process of our economic reforms are on the right track is vindicated by the performance of the economy since the launch of the reforms. Between 1981-82 and 1990-91, that is the decade before the reforms, the economy grew at 5.6 per cent on a compound average basis. Between 1992-93 and 2010-11, the economy grew at an average rate of 6.8 per cent per annum, a significant improvement over the pre-reform period.

Coming to the more recent period, economic growth in the six year period from 2005-06 to 2010-11, despite the crisis-affected year of 2008-09, was at an average of 8.6 per cent. This clearly represented an acceleration in the pace of growth and marks a distinct break from any previous five year period. Per capita GDP grew by an average of 7.0 per cent in these six years.

Under the severe impact of the global crisis, the Indian economy registered a growth of 6.7 per cent in 2008-09 after having registered over 9 per cent rate of growth for three successive years. By any standards, the Indian economy was able to protect itself reasonably well in the turbulent conditions of the financial crisis.

Initially the growth rate in 2011-12 was forecast by the Economic Advisory Council to be 8.2 per cent. However, subsequent events have forced us to revise it downwards. The monsoon has been good and we should expect to see agriculture grow reasonably well. The expected growth rate of 3 per cent in agriculture will be on top of a strong growth of 6.6 per cent in the previous year. It is in the case of industry some slackness has been noticed. The growth rate of indices of industrial production both in July and August 2011 have been below 5 per cent. While growth may pick up in the second half, the overall growth rate in industry will be well below the initial expectation of 7 per cent. The world economic situation is also not very encouraging. Under these circumstances, the growth rate during the current year may be between 7.5 per cent and 8 per cent.

In this context, a frequently asked question is whether India has the potential to grow at 9 per cent in a sustained way. India's savings rate has crossed 34 per cent of GDP. The investment rate has exceeded 36 per cent of GDP. Even with an incremental capital-output ratio of 4, this should enable the Indian economy to grow at 9 per cent. Thus the broad macro economic parameters relating to savings and investment are conducive for achieving a high growth rate. However, for this to happen, we also need to remove the constraints that may come in the way.

Distribution of Income

Before going into the issue of constraints let me turn to the issue of distribution of income. While growth is important, it is necessary to remember that it is not the only dimension for measuring performance or achievement. It is equally important to know who benefits from growth. There has been considerable dispute in this country in estimating the people below the poverty line. There is no consensus yet on what constitutes the poverty line. According to the methodology adopted by the Planning Commission until recently, the number of people below poverty line in 1993-94 was 36.0 per cent. According to the same methodology, it came down to 27.5 per cent in 2004-05. However, the Tendulkar Committee, by adopting a slightly different methodology, came to the conclusion that the overall poverty ratio was 45.3 per cent in 1993-94 and 37.2 per cent in 2004-05. While the Tendulkar Committee estimates are higher than the earlier estimates, both methodologies show that the reduction in the poverty ratio was in the range of 8 to 8.5 per cent. While growth has contributed to reducing the poverty ratio, it has to be acknowledged that the absolute level of poverty is still high. Truly we have miles to go before eliminating poverty. We need to ensure that the growth process is such as to include every section of the economy. We must maintain, nevertheless, a high growth rate which will alone enable the Government to raise the resources to meet the various socio-economic obligations.

One aspect of the growth process is balanced regional development. It is normally expected that with economic development, the per capita income of the States will show a tendency to converge. Comparing the two periods of 1993-94 to 1999-00 and 1999-00 to 2008-09, data do not show a convergence. However, there is a strong evidence of catching up by the lower income States. The median growth rate increased one-and-a-half times between the two periods, increasing from 3.9 per cent in the earlier period to 5.7 per cent in the latter period. States with lower per capita GSDP like Assam, Orissa, UP and Bihar have made significant gains in growth rates in the latter period. Notwithstanding these gains, convergence was subdued because some of the higher income States like Gujarat, Kerala, and Haryana also posted high growth rates. In other words, what the recent data indicates is that while most of the lower income states have shown stronger growth rates, several of the higher income states have also shown an increase in the recent period.

Macro-economic Concerns

There are a few areas where immediate engagement of the policy makers is needed. In the short run, managing inflationary pressures is the biggest challenge. I shall talk about it in some detail later.

A second concern relates to the balance of payments. India's current account deficit remained low till 2008-09. Since then it has started climbing and the current account deficit was 2.8 per cent of GDP in 2009-10. In the first half of 2010-11 the current account deficit remained very high at 3.7 per cent of the GDP. However, in the second half, exports picked up strongly while import growth was weaker. It is now estimated that the current account deficit for this year is 2.6 per cent of the GDP. We have had no problems so far in financing the current account deficit. Even in 2010-11, capital flows were adequate to cover the current account deficit and add to the reserves $15 billion. Efforts must be made to keep the current account deficit around the manageable level of 2.5 per cent of GDP. This is desirable to impart much needed stability on the external payment front and to reduce the risk the domestic economy runs from volatility in international financial markets.

Another critical challenge on the way forward is fiscal consolidation which is a necessary pre-requisite for sustained growth. In the wake of the international financial crisis, India like many other countries adopted an expansionary fiscal policy in order to stimulate demand. As a consequence, the fiscal deficit of the Government of India which was coming down started rising. In 2008-09, the fiscal deficit was 6 per cent of GDP. It rose to 6.4 per cent in the next year. Unlike other countries in the advanced world, where there is a continuing debate regarding when to terminate the expansionary fiscal policies, we in India have taken a decision to initiate the process of fiscal consolidation. In 2010-11, the fiscal deficit came down to 4.7 per cent of GDP and it is projected to fall to 4.6 per cent in the current year. There are concerns whether we will achieve this. To gain credibility, it is important that fiscal deficit remains close to this level. Over the medium term, we should aim to reach the FRBM target of 3 per cent of GDP.

Medium Term Constraints

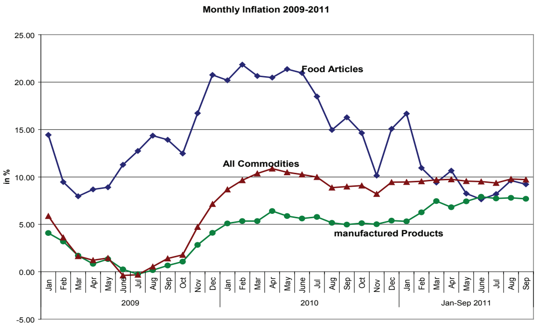
In the medium term, the two sectors which pose a major challenge are the farm economy and the power sector. The first of these, farm economy is primarily constrained by the relatively low levels of yield in major cereal crops and pulses as compared to other Asian economies especially China. We have large science and technology establishments for agricultural research. But the results in terms of productivity gains leave much to be desired. Necessary steps must be taken to revitalize the traditional crop agriculture which is vital to food security and farm income. Equally, as shifts in demand occur reflecting changes in income and taste, agricultural production must also respond to them. The last two years have clearly shown how a decline in agricultural production can cause serious distortions in the economy. It is, therefore, imperative that we aim at GDP originating from agriculture and allied activities growing at 4 per cent per annum.

The second challenge for the country is the shortage of physical infrastructure of which the single most important item is electricity. Shortage of electric power leads not only to direct production losses but also results in inefficiency in a broad range of areas impacting profitability and competitiveness. Recent data clearly indicate a short fall in achieving the targets for capacity creation. This is despite the fact that the achievement in capacity creation in the first four years of the 11th Plan is higher than that in the first four years of the 10th Plan. Government is the largest player in production, transmission and distribution of power and a high order of Government intervention in capacity creation and other supportive components of electricity business is crucial to sustaining a high growth rate of 9 per cent. A more aggressive path of capacity creation must start immediately. Constraints such as the availability of coal, land acquisition and environmental issues need to be tackled so that the desired growth in capacity expansion can be achieved.

Current Inflation

We have had two years of high inflation (Chart 1). 2009-10 was badly affected because of the deficient monsoon. Foodgrain production declined by 17 million tonnes. The decline in the production of rice alone was 11 million tones. As a consequence, inflation was triggered by the increase in foodgrain prices. Food inflation stood at as high as 21 per cent in February 2010. Overall inflation as measured by the wholesale price index touched the peak of 10.9 per cent in April 2010. It was expected that inflation would moderate through 2010-11. It in fact started happening till November 2010. However, prices started rising after that. As of March 2011, year on year inflation had touched 10.0 per cent. While the food price inflation of 2009-10 was triggered by the rise in foodgrain prices, in 2010-11 it was triggered by the rise in the prices of vegetables, fruits and eggs, meat and fish. The increase in vegetable prices has been significant. The late rains had a severe impact on the supply of some vegetables including onion. Inflation in vegetables rose to 34 per cent in December 2010 and 67 per cent in January 2011. Normally, vegetable prices show a seasonal decline during winter months. During 2010-11, prices of raw cotton rose on an average by 43 per cent. The persistence of food inflation led to the spread of inflation to other sectors. Inflation in manufactures rose from 5.35 per cent in March 2010 to 7.4 per cent in March 2011. In 2010-11, the weighted contribution of the manufacturing sector to total inflation was 41.8 per cent.

Inflation continues to remain an area of concern in the current year. As of September 2011, the headline inflation in wholesale price index stood at 9.7 per cent. While inflation in food articles has eased from 10.6 per cent in April 2011 to 9.2 per cent in September 2011, inflation in manufactured products has risen from 5.3 per cent in January 2011 to 7.7 per cent in September 2011. Primary food inflation still remains at a fairly high level. The rationalization process in the pricing of petroleum products is still to be completed and this may have an impact on price levels in the coming months. Factoring all these, the headline WPI inflation would remain high till December 2011. One could expect significant easing in the last quarter of the fiscal year and inflation may come down to 7.0 per cent in March 2012.



Supply side constraints have to be necessarily eased in order to continue with growth along with price stability. However, interventions to reduce supply constraints take some time to mature. In our case, at least as far as foodgrains are concerned, use of the official stocks in an imaginative manner can help to keep prices under control.

Thus the extraordinarily high level of inflation seen in the last two years is due to certain severe supply constraints, particularly of agricultural products. The fact that inflation is triggered primarily by supply side shocks does not mean that monetary policy has no role to play in such conditions. As mentioned earlier, food price inflation, if it persists long enough, gets generalized. Thus, monetary policy and at one step removed, fiscal policy have to play their part in containing the overall demand pressures.

It is only in this context one can understand the series of actions taken by the RBI to raise the policy rate to control inflation. At the same time, one has also to note that industrial production is slackening. In August 2011, the index of industrial production rose by 4.1 per cent. In July 2011, it rose by 3.3 per cent. Thus, industrial production has remained subdued in the last few months. While this factor must be taken into account, it is nevertheless important for the monetary authorities to focus primarily on taming inflation. Inflation has remained above 9 per cent continuously for more than ten months. The regime of tightening can come to an end as inflation shows definite signs of decline.

There has been a considerable debate on what is an acceptable level of inflation. I had in a different context used the term threshold level of inflation, defining it as the level beyond which costs of inflation begin to rise sharply. The Chakravarty

Committee (of which I was a Member) regarded the acceptable rise in prices as 4 per cent. This, according to the Committee, will reflect changes in relative prices necessary to attract resources to growth sectors. When growth takes place, it does not happen uniformly in all the sectors. Thus maintenance of absolute price stability meaning thereby zero rate of increase in prices may not be possible. Nor is it desirable. Obviously, there is a certain amount of judgement involved in determining the acceptable or threshold level of inflation. One has to take into account not only the impact on output but also the distributional implications.

In the early decades after Independence, the argument that inflation was endemic in economic growth led to very steep increases in prices. We should not let that happen in the years of high growth. We must remain committed to maintain inflation at a low level. High growth does not warrant a higher level of inflation. We must use all of our policy instruments interventions in the foodgrains market, monetary policy and fiscal policy to bring down the current inflation and re-anchor inflationary expectations to the 5 per cent comfort zone.

Need for High Growth

As mentioned earlier, with the investment rate touching 38 per cent of the GDP, the economy should be able to grow at 9.0 per cent. Pushing the economy beyond that will run into problems. First of all, it will be difficult to achieve the required investment rate, second, pushing the economy beyond its capacity would result in strong inflationary pressures re-emerging. The deficit in the current account of the balance of payments will also widen. It is, therefore, prudent to aim at a growth rate of 9 per cent.

Some people raise a question whether it is necessary at all to grow at this rate. Growth is an important factor in generating employment and reducing poverty. Obviously, the composition of growth is equally important. As I mentioned earlier, particular focus on agriculture is extremely important. Growth in agriculture is necessary not only from the point of view of ensuring food security but also in making a dent on poverty. Nevertheless, overall growth is an important factor while examining the progress in terms of living standards. With population growth rate coming down, a strong growth will mean a substantial growth in the per capita income. If we grow at 9 per cent per annum, India's per capita GDP will increase from the current level of \$1,600 to \$8,000-10,000 by 2025. Then we will become part of the middle income group of countries. Without a strong growth, we will not be able to provide employment to the growing number of young people who will join the labour force. Analysis of the preliminary NSSO data for 2009-10 suggests that, compared to 2004-05, there has been a reduction of about 3-4 percentage points in the poverty ratio. Continued strong growth will help to accelerate the declining trend in poverty ratio. In the recent period, we have launched a number of schemes aimed at broadening the base of growth. These include employment guarantee scheme, universalisation of education, expansion of rural health and food security. All these programmes have made a substantial demand on public expenditure. This has been made possible only because of the strong growth that we have seen in recent years. Growth has facilitated raising more resources by the Government.

Development has many dimensions. It has to be inclusive; it must be poverty reducing and it must be environment-friendly. We need to incorporate all these elements in the growth process. However, at our present stage of development, we cannot afford to sacrifice growth. It is key to improving the living standards of our people. A strong and balanced growth will enable the economy to achieve multiple goals including lowering inflation. Equity and growth should not be posed as opposing considerations. They must be weaved together to produce a coherent pattern of development.

Financial Sector and Growth

In any economy, the financial sector plays a major role in the mobilization and allocation of savings. Financial institutions, instruments, markets which constitute the financial sector act as conduit for the transfer of resources from net savers to net borrowers. The gains of the real sector of the economy depend on how efficiently the financial sector performs the basic function of financial intermediation.

The financial sector expansion can occur along two routes. These are: (1) 'demand following' and (2) 'supply leading'. In the first situation, financial institutions come into existence in response to the demand for financial services. In the second situation, financial institutions are set up ahead of demand. The Indian financial system has experienced both these types of phenomena. The extension of banking and other financial facilities to a large cross section of the people stands out as significant achievement. As a ratio of GDP at current prices, bank deposits have increased from 18 per cent in 1969-70 to 73 per cent currently. Ongoing financial sector reforms are aimed at promoting a diversified, efficient and competitive financial sector with the ultimate objective of improving the allocative efficiency of available resources. In many ways, the coming decade will be a defining decade for India. During this period, India will transit from being a low income country to a middle income country. The Indian banking system must play its role in the evolution of this process. It is important that the banking system must develop to meet the needs of a growing and diversifying economy. I am sure that Federal Bank will play its role in this challenging task.

Dr. C. Rangarajan, through the eyes of Anjan.

20-year old Anjan is a cerebral palsy affected youth with multiple challenges. The son of Mr. Sathees Kumar, Manager, Federal Bank, he makes the entire Federal Family proud. Suffering from complete hearing and speech impairment, he was diagnosed with acute congenital glaucoma leaving eyesight in his one eye only. He is totally crippled and his mobility is limited to crutches, a stature he could achieve after a series of orthopaedic surgical interventions.

Anjan Satish

In spite of all these challenges, he had his schooling in a normal school up to his 10th standard. He has shown his talent in drawing and painting ever since his early childhood with his uncontrollable hands. Lines and drawings were his method of communication with the world he sees around. He lived with computer and colors. He made an exhibition of his paintings when he was just 10 years old.

He is talented in painting, sketching, cartoons, caricature, 3D modelling, animation, 3D architectural presentation etc. He is the youngest member of Kerala Cartoon Academy. His works are posted through various web pages and are available on YouTube/satlet07, Facebook, Orkut, Cartoon Academy pages and blogs (Anjan's gallery). He is presently serving at Adarsh Charitable Trust, caring for children facing similar challenges, teaching them and supporting them.

Fedbank Hormis Memorial Foundation Commemorative Lecture Series

The trust and its activities were inaugurated by the then Union Finance Minister Shri. P. Chidambaram at Ernakulam on 18.10.1996. The following dignitaries have delivered lectures over the years.

Lecture by	Topic
Shri. P. Chidambaram (Hon. Union Finance Minister)	Indian Banking, New Directions
Shri. S. Venkitaraman (Former Governor, Reserve Bank of India)	India and Globalisation
Shri. M. M. Jacob (Governor of Meghalaya)	Governance in 21st Century Needs a Paradigm Shift
Shri. Montek Singh Ahluwalia (Deputy Chairman, Planning Commission)	Future Reforms in Banking Sector
Dr. V. Kurien (Chairman, Institute of Rural Management, Anand)	Rural Development Banking - Some Reflections
Shri. N. R. Narayana Murthy (Chairman and Chief Mentor, Infosys Technologies Ltd.)	Global Capitalism and Modern Corporation: Development in Strategies for Corporate Leadership Governance & Social Responsibilities
Shri. Arun Jaitley (Former Union Minister for Law & Justice and Commerce & Industry)	Reforms in Legal Systems - Challenges Ahead
Shri. V. Leeladhar (Deputy Governor, Reserve Bank of India)	Taking Banking Services to Common Man - Financial Inclusion
Shri. M. Damodaran (Former Chairman, SEBI)	Capital Markets -Yesterday, Today and Tomorrow
Dr. Shashi Tharoor (Former Under Secy. General, United Nations)	The Global Financial Crisis and India's Incomplete Transformation
Shri. Madhavan Nair (Former Chairman - ISRO)	Technological Challenges for National Development

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