International Economic Environment and Indian Growth

Suresh D Tendulkar

Dr. Subbarao, Governor of the Reserve Bank of India, Dr. Asish Saha, Director of the National Institute of Bank Management, Professor Kaveri, Professor Swarup, Faculty Members, graduating students, ladies and gentlemen:

I am grateful to Dr. Subbarao and Dr. Saha for inviting me to be the Chief Guest at the Convocation of the Post-Graduate Programme in Banking and Finance today. My happiness in being amongst you is manifold. One, I have always held the Reserve bank of India as an institution in very high esteem because of the successful efforts it has been making in maintaining financial stability, control over inflation, promoting growth and enhancing the reach and inclusiveness of financial institutions. Two, having been a life-long teacher at the Delhi School of Economics till my retirement in 2004; it is always a pleasure to reconnect with the student community on a happy occasion of their successful completion of the course. Three, I have had an enjoyable time working with Dr. Subbarao during his days as Secretary with the Economic Advisory Council to the Prime Minister of which I was a member. My admiration for him has enhanced as he has been very ably steering India's monetary policy through a very difficult international and domestic economic environment. This occasion provided an opportunity of catching up with him since he moved to Mumbai.

Let me Turn to the Theme of My Address

As all of you are aware, after experiencing virtually uninterrupted growth since the beginning of the millennium, the world economy has been going through a roller coaster ride over the last couple of years. There has been a turbulence in the financial markets since the onset of the sub-prime crisis in July 2007 in the United States resulting in rising food, oil and commodity prices fuelling worldwide inflation till the collapse of the Lehman Brothers in September 2008 after which there were steep declines in energy, food and commodity prices and deeper than anticipated recession in the advanced industrial economies. In a volatile international economic environment, the changes in the prospects for growth in

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the real economy and in the world trade were so sudden that the IMF forecast for growth in the advanced economies for the current year 2009 was lowered progressively from plus 1.3 per cent in April 2008 through four more quick revisions in July, October, November 2008 and January 2009 and finally to minus 3.8 per cent in April 2009! Similarly, 2009 forecast of world trade volume growth turned from plus 3.8 per cent in April 2008 to minus 11.0 per cent in April 2009.

With the beginning of systemic reforms in 1991, India has been re-integrating progressively with the global economy. Just as the Indian economy has been demonstrably benefited from the virtually uninterrupted boom in the world economy till 2007-08, it is obviously not possible for us escape the consequences of recession in the advanced countries that has resulted mainly from the recent instability in the international financial markets.

Before examining the impact on the Indian growth, it is important to bear in mind two general points. First, let us remember the cold fact of history that boom and bust cycles resulting from periodic large world-wide demand-supply imbalances are inherent and inescapable parts of the world capitalist economic growth process from which no globally integrated economy can remain immune. Economic theory can at best devise policies for reducing the duration and intensity of both the extremes but cannot eliminate the emergence of boom-bust economic cycles altogether. Every globalizing economy has to develop with experience an institutionalized resilience to cope with the excesses of both booms and busts. Second, my judgment is that large demand-supply imbalances are more likely to occur in the financial markets than in the markets for goods and services. The reasons have to do with easier shiftability of financial (in comparison with physical) assets and greater role played by quick changes in perceptions regarding expectations, sentiments, business confidence and herd behaviour in the financial markets. The volume of international financial flows and the concomitant foreign exchange transactions have been expanding progressively since the 1980s. Late Peter Drucker had noted in the 1980s that the volume of foreign exchange traded in world currency markets per day was several times that necessary to finance the volume of goods and services traded in a year! It appears inevitable, therefore, that while the financial markets provide the much-needed lubricant for the smooth and efficient operation of the real economy, they have come to develop a dynamics of their own not often related to but impacting the operations of the markets in goods and services. This expands both opportunities and risks at the same time.

Getting back to the India story, let me start with a brief historical perspective on the Indian growth performance. Post-Independence India was trapped in low-growth equilibrium of 3.6 per cent per annum with wide variations around the average (coefficient of variation (cv) of 95 per cent) for three decades between 1950-51 to 1980-81. Sectorally, industrial sector dominated with average annual growth of 5.25 per cent. A step-up in the aggregate growth rate to 5.4 per cent with a lower cv of 39 per cent between 1981-82 to 1990-91 ended in unsustainable fiscal and foreign exchange payments deficits and resulted in a beginning of a wide-ranging systemic reforms involving domestic liberalization and integration of the economy with the rest of the world. The decade of the 1980s was the one when the services sector appears as the major contributor to growth with the annual growth of 6.6 per cent compared to 6.2 per cent registered by the industrial sector. Excluding the year 1991-92 as the year of steep fiscal adjustment, during the fifteen year period between 1992-93 and 2007-08, the Indian economy clocked 6.8 per cent annual growth in real GDP with a still lower cv of 26 per cent. Sectorally, the service sector dominance became more conspicuous during this period with 8.4 per cent annual growth in comparison with 7.0 per cent registered by industry. During the five years ending in 2007-08, the economy appears to have entered a still higher trajectory of 8.9 per cent annual real GDP growth with a very low 9.0 per cent cv on the strength of a healthy agricultural growth of 4.9 per cent, 10.1 per cent for services and 9.4 per cent for industry. More remarkably, gross domestic investment rate at current prices shot up from 27.6 per cent in 2003-04 to 39.1 per cent in 2007-08 financed mostly from the corresponding rise in gross domestic savings rate from 29.8 per cent to 37.7 per cent. It is worth noting that although helped immensely by the booming international economy, the major contribution to the recent Indian growth came from the strength of domestic demand and domestic savings which made it less vulnerable to though not immune from the external shocks.

As a result of the turmoil in the international economic environment, the Indian economy was subjected to rapid changes during 2008-09. Rising commodity prices and inflation combined with appreciation of the Rupee in the face of heavy capital inflows marked the first half when the real GDP growth slowed down to 7.8 per cent compared to H1 2007-08. This was followed by a steep reduction in both commodity prices and inflation and a depreciating Rupee resulting from heavy capital outflows in the second half the GDP growth slowed down further to 5.8 per cent from 8.9 per cent in H2 2007-08. In adjusting to these sudden and rapid changes, the Indian growth rate for the entire year slowed down from 9.0 per cent in 2007-08 to 6.7 per cent in 2008-09. It is important to underline the basic difference between India and the advanced industrial economies. In the industrial economies of the West, demand slump from recession (i.e. Contraction of real GDP) swamped the impact of falling commodity prices affecting all the sectors almost uniformly. In contrast, impact of slowdown (not recession) in demand from decline in growth in India has been uneven across sectors. Enterprises dependent mostly on domestic demand were not affected as severely as those directly dependent on exports to advanced countries. Similarly, for downstream input-using enterprises which suffered from rising input prices in the first half of 2008-09, demand slowdown was offset in varying degrees by falling commodity prices in the second half. Since monsoons during the last five years have been normal, rural demand has been growing at a healthy clip largely unaffected by world recession. Industries which have been catering to the rural demand have not been affected by demand slump. There has been, however, what I have been calling irrational import of psychology of gloom and doom from abroad that has led to extreme risk-aversion amongst our bankers, investors and mostly metropolitan consumers. It was irrational in the light of objective conditions - well-capitalized Indian banks with low NPAs, reasonably healthy balance of payments with comfortable foreign exchange reserves and the strength of domestic demand especially rural --obtaining in the Indian economy. However, replicating the behaviour of extreme risk-aversion in the advanced countries, it resulted in bankers unwilling to trust borrowers and lend, consumers becoming jittery about their future earnings and hence averse to spend and investors putting their investment plans on the back burner and contributed further to the slowdown. The slowdown has been offset in varying degrees by rapid changes in monetary policy rates and deployment of other monetary instruments by the Reserve bank of India in the second half of 2008-09, three fiscal stimulus packages in December 2008, January 2009 and again after the interim budget in February and the public sector banks slowly lowering their lending rates. After the return of the UPA Government at the Centre with comfortable margin in the recent general election and the prospect of political and economic stability has further improved the outlook for an early recovery hopefully during the next six months. With the stabilization of the international financial market, international credit flows are being slowly restored and prospects for capital inflows have improved. Early indications are that real economies in the advanced countries might also show slow revival which would strengthen the domestic growth impulses. I am, therefore, quite optimistic about the growth in 2009-10 to be at least as high as in 2008-09 with a resumption of higher growth trajectory thereafter.

The slowdown in the Indian growth which may continue during the current year before revival is bound to generate pains of adjustment in terms of slower growth of jobs and earnings and intensification of competition. However, validating the age-old dictum that necessity is the mother of invention, historically, economic slowdown has historically always been found to generate new and challenging opportunities for productivity-enhancing and efficiency-raising innovations to minimize the incidence and duration of adversity and in the process advancing the frontiers of knowledge and technology that enhance human welfare. Consequently, challenging times are ahead for your exciting participation in India's ongoing economic transformation while aggressively going global in establishing benchmarks of excellence.

Let me end by offering my heartiest congratulations on successfully completing the prestigious Post-Graduate Programme in Banking and Finance and my very best wishes in your future professional endeavors.

Thank you.