

India - Managing the Challenges of Growth



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Warning!

- The views expressed in this presentation are personal and are not necessarily those of the IMF, its Executive Board, or its management.



Roadmap of presentation

- Why is India booming?
- Can India manage its capital inflows?
- Can India kill the Bangalore bug?



Roadmap of presentation

- Why is India booming?
- Can India manage its capital inflows?
- Can India kill the Bangalore bug?

India's economy has gone from the "Hindu rate of growth"...

- Growth averaged 2.9 percent in the 1970s

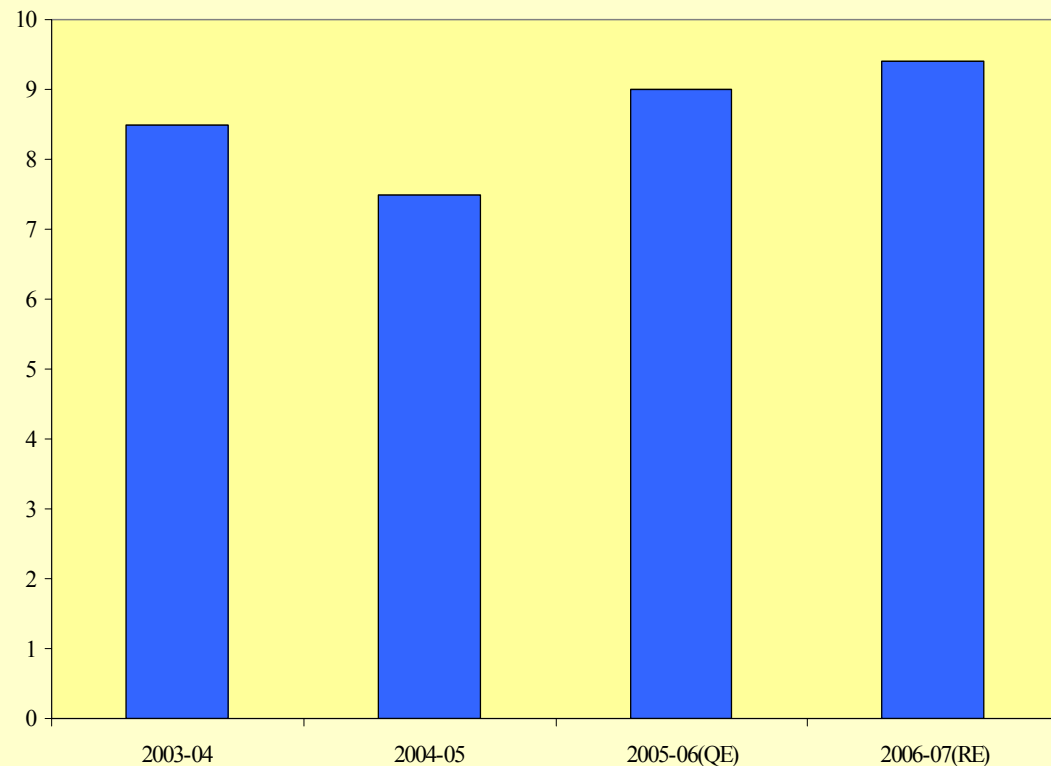




...to a growth superstar

- GDP has been growing at 8.6 percent for the past four years!

India - Real GDP growth (percentage change)



Source: CSO, RE-Revised estimates; QE-Quick estimates

The old India

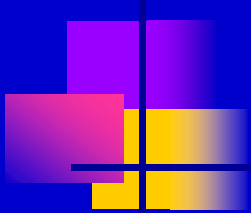


The New India



The new West!





- What has happened?
- What is driving India's growth?



India's path has been unusual

- It has long had one of the most closed economies in the globe
 - Exports were small
 - Capital flows controlled
 - Almost no FDI
- Domestic activity was traditionally controlled through the license-permit raj
 - Investment was low
 - Manufacturing uncompetitive

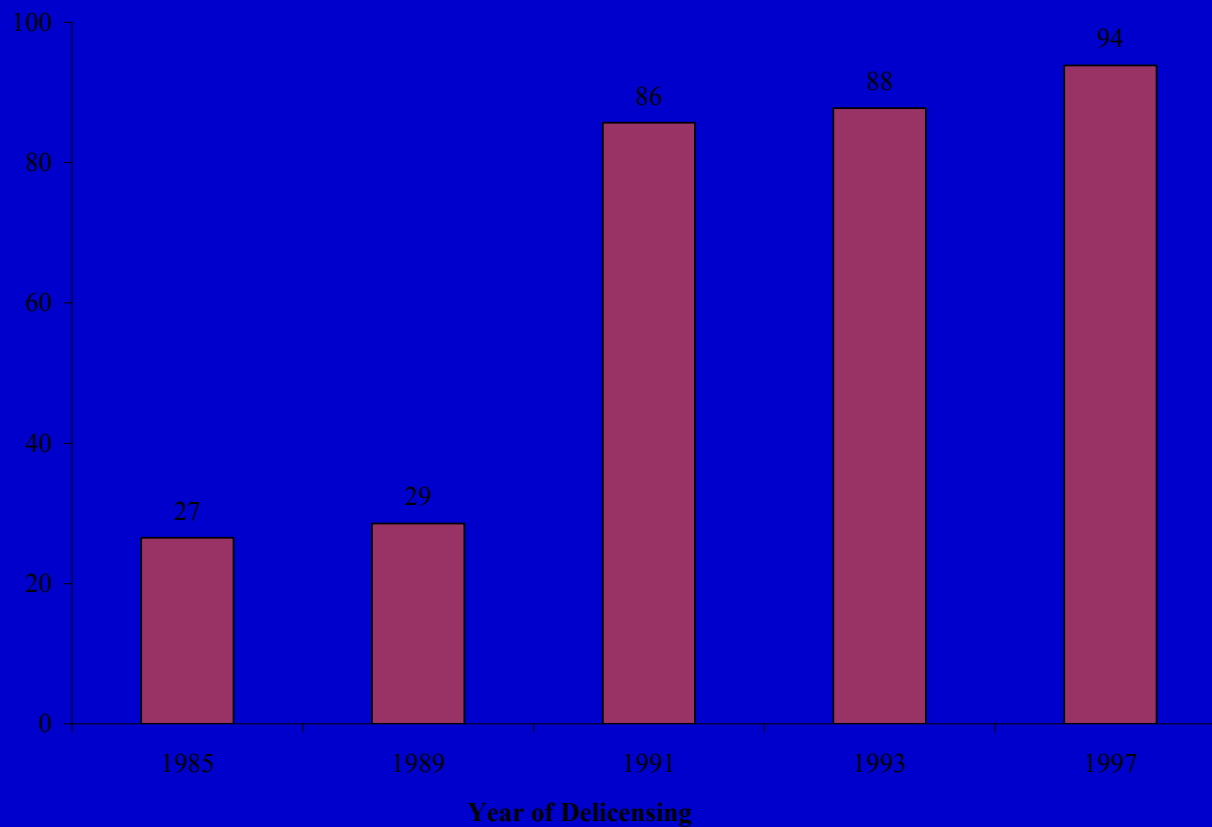


Rise of the private sector

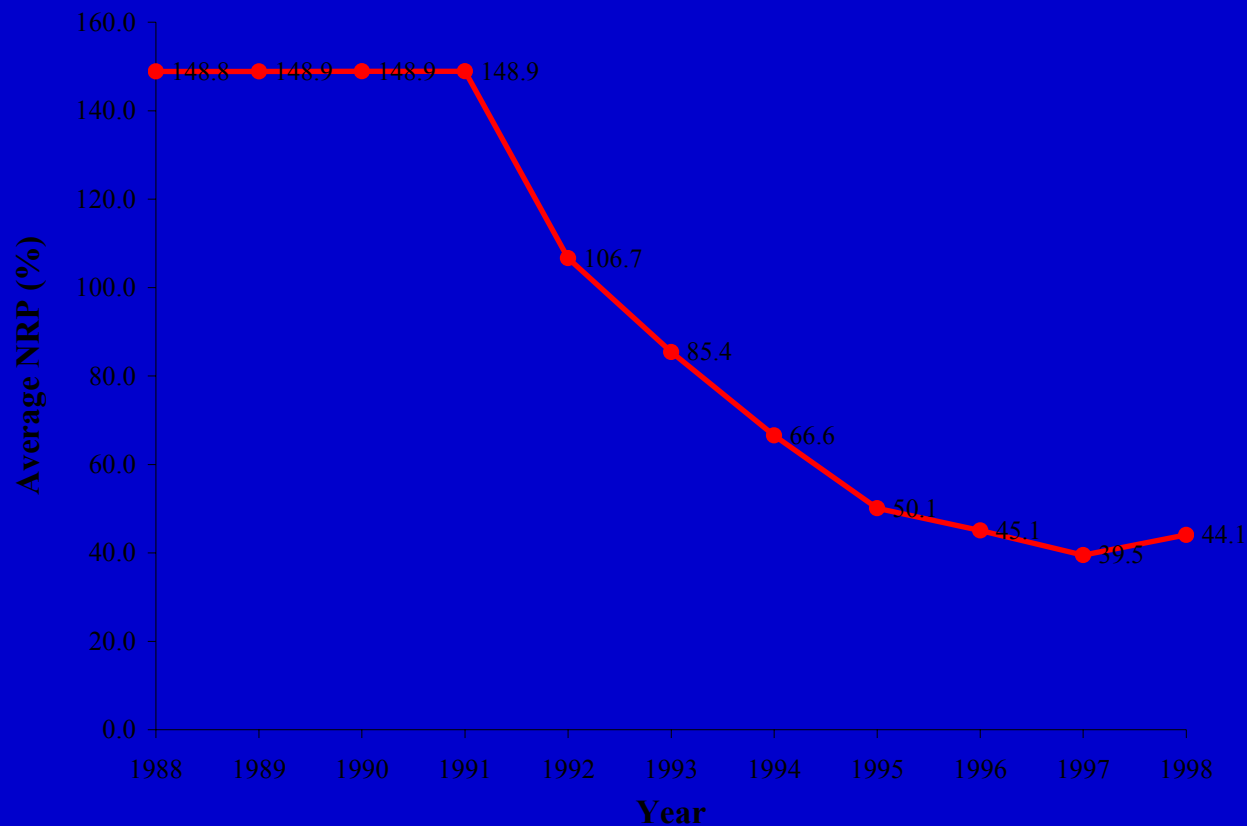
- After the 1991 crisis, the government embarked on a sweeping set of reforms:
 - Budget deficit was reduced, with further impetus from the Fiscal Responsibility and Budget Management Act
 - Financial sector was deregulated

The licence-permit raj was dismantled

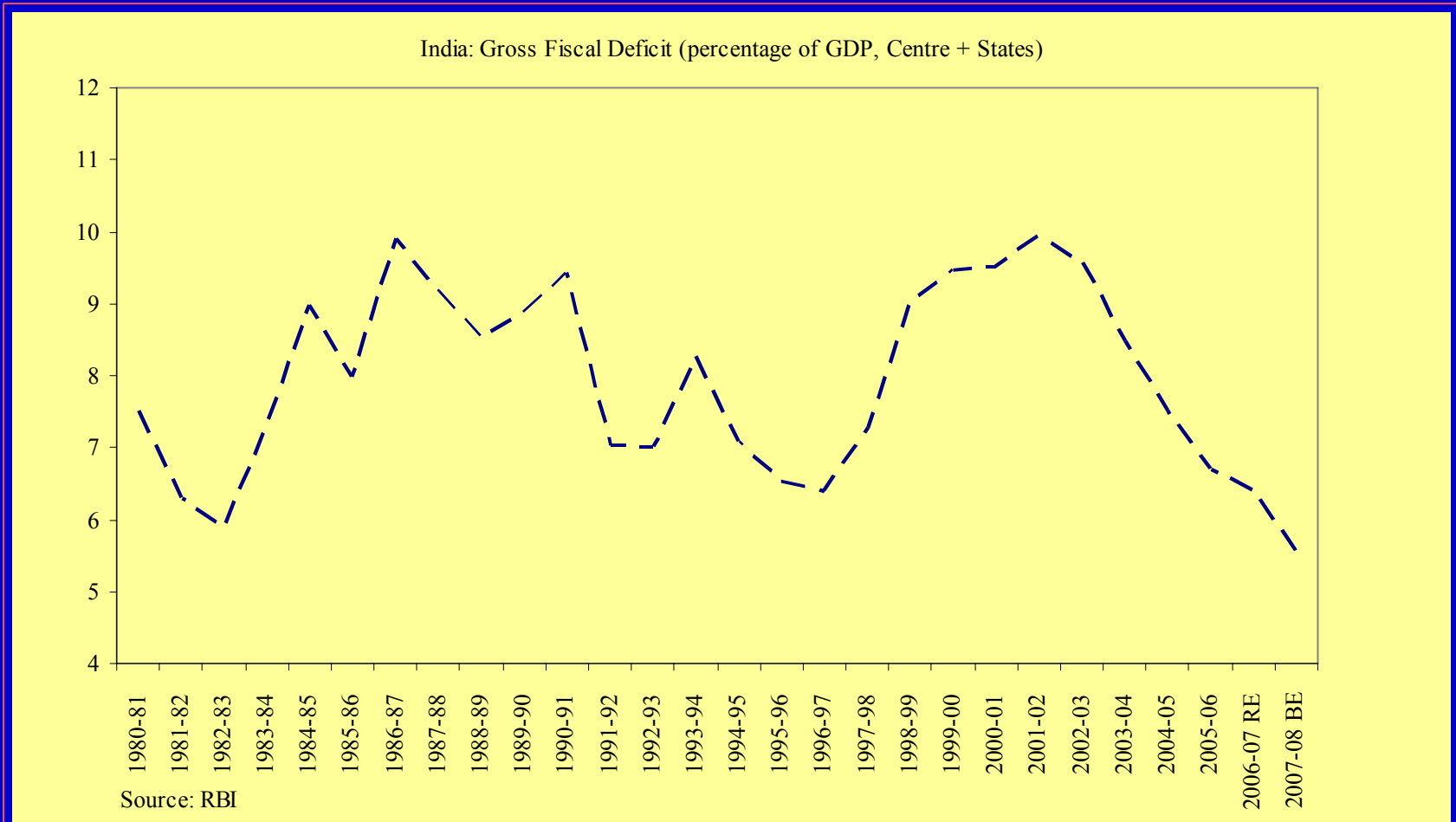
Cumulative share of delicensed industries



Protectionist walls came tumbling down

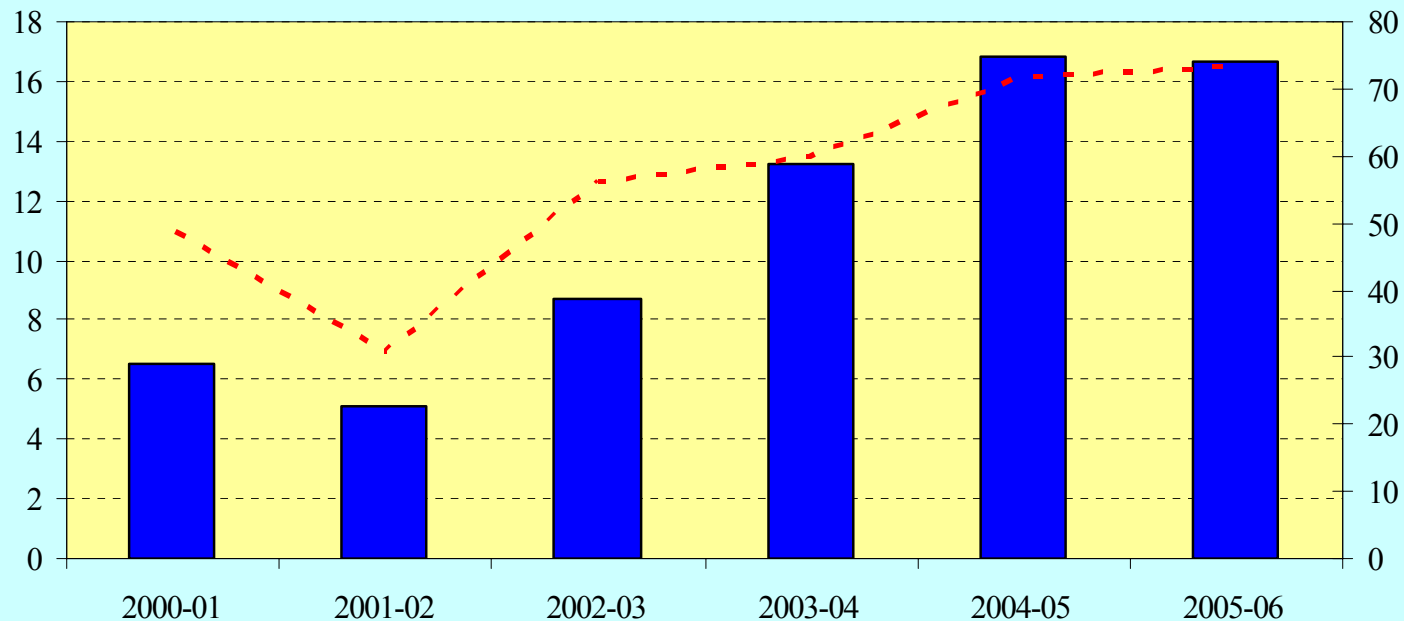


The fiscal deficit was tamed



This has created an environment where business can be profitable...

Corporate Performance Indicators (per cent)

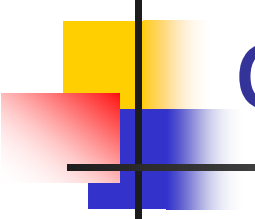


Source: RBI, 2007

■ PAT/Net Worth (Per cent)

- - - Retained Profits / PAT (Per cent, right scale)

...more profitable than in other countries!

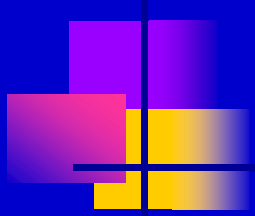


Return on Equity						
All Firms						
China	4.78	2.60	4.18	3.85	1.74	
Hong Kong SAR	-7.10	-8.84	-4.53	1.70	0.43	
India	10.42	8.28	11.67	18.70	22.35	
Indonesia	4.59	6.47	2.22	5.18	5.32	
Japan	0.56	-0.87	0.76	4.14	5.45	
Korea	-1.27	1.35	1.34	5.65	4.94	
Malaysia	-1.14	0.00	1.77	3.11	3.13	
Philippines	-10.15	-13.55	-7.22	1.38	-1.87	
Singapore	-2.54	-2.23	3.33	7.92	6.58	
Taiwan POC	-1.21	1.85	6.06	5.55	2.61	
Thailand	4.90	7.78	12.91	13.26	11.53	



How have these changes affected India's development path?

- Just last year, a noted commentator wrote that India's development path remains unique
- He noted that India's growth continues to rely more on:
 - consumption than investment
 - the domestic market than exports
 - services than manufacturing
- Is this really true?
 - Let's look at the data



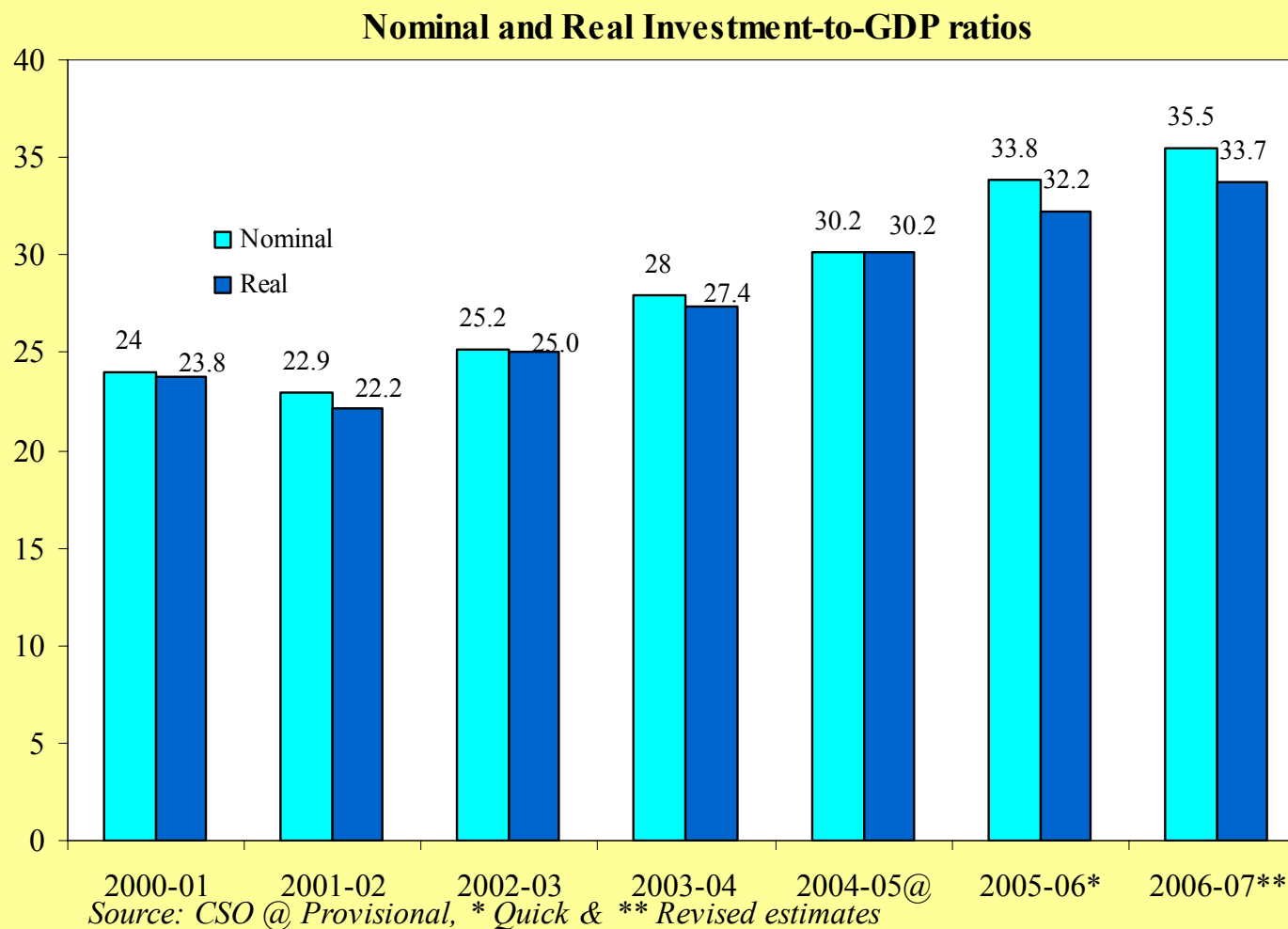
- What about the claim that India's boom relies much more on consumption than investment?



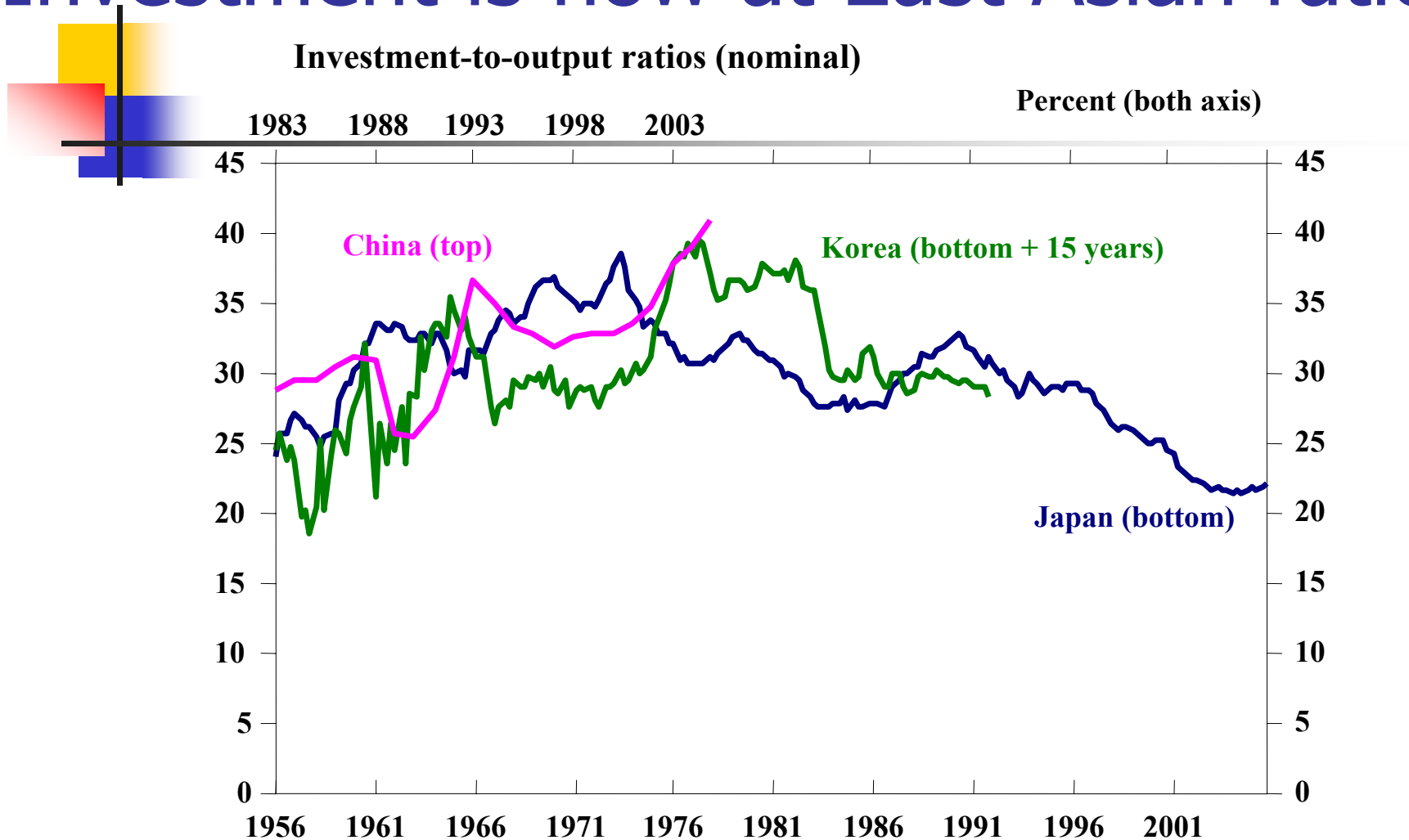
Wrong!

- High profitability has sent firms on an investment spree

Investment has increased by 10 percentage points of GDP since 2002/03



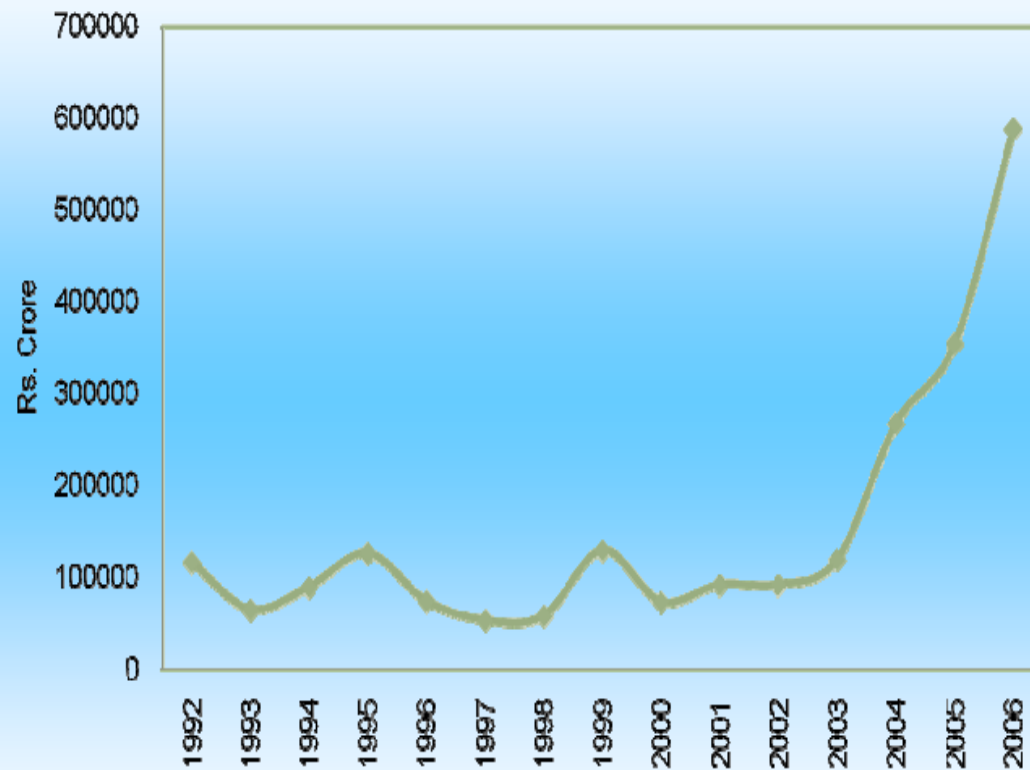
Investment is now at East Asian ratios!



Source: IMF World Economic Outlook, September 2006
and National Sources

...and this process looks set to continue

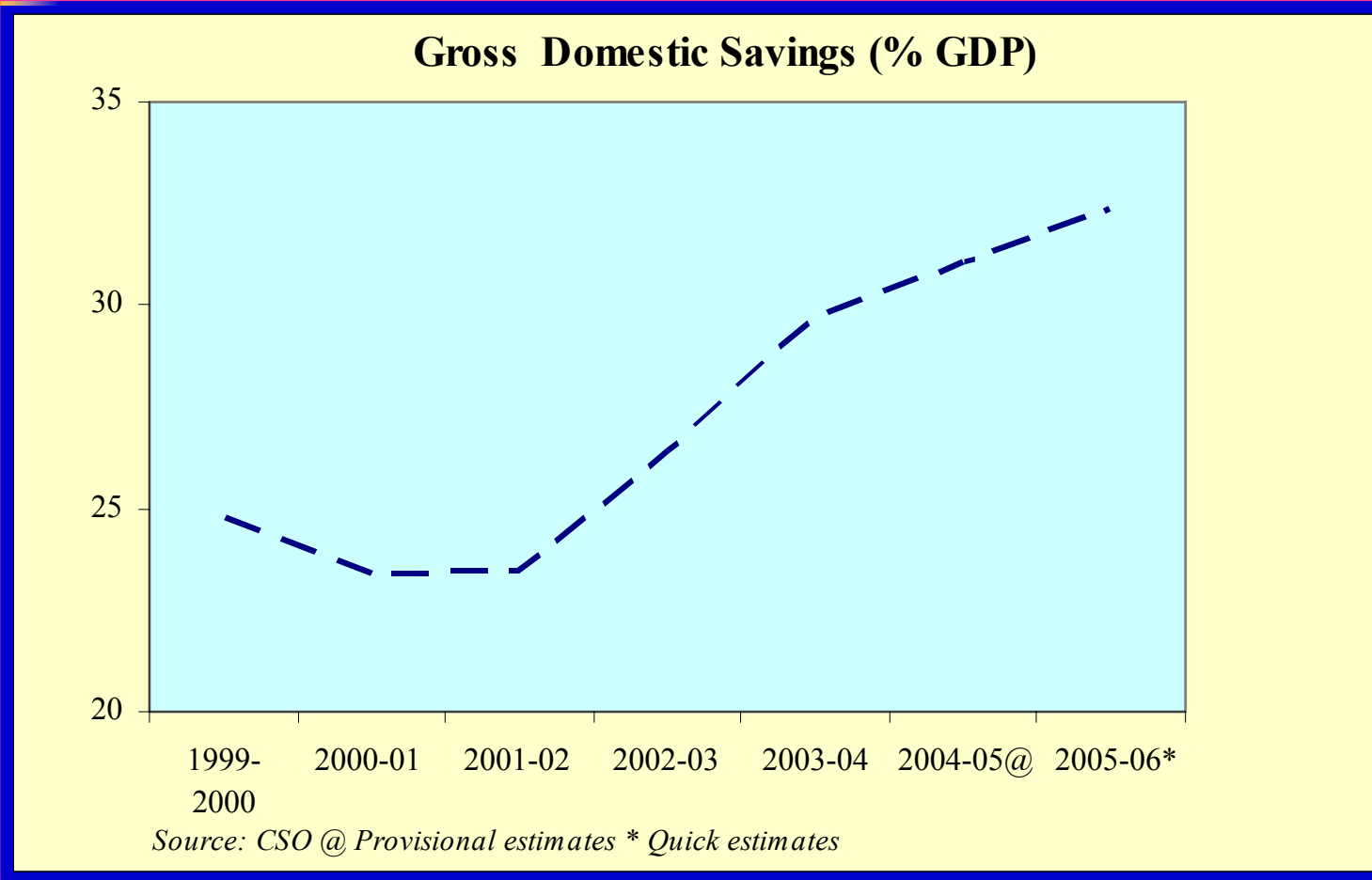
Proposed Industrial Investment: Amount



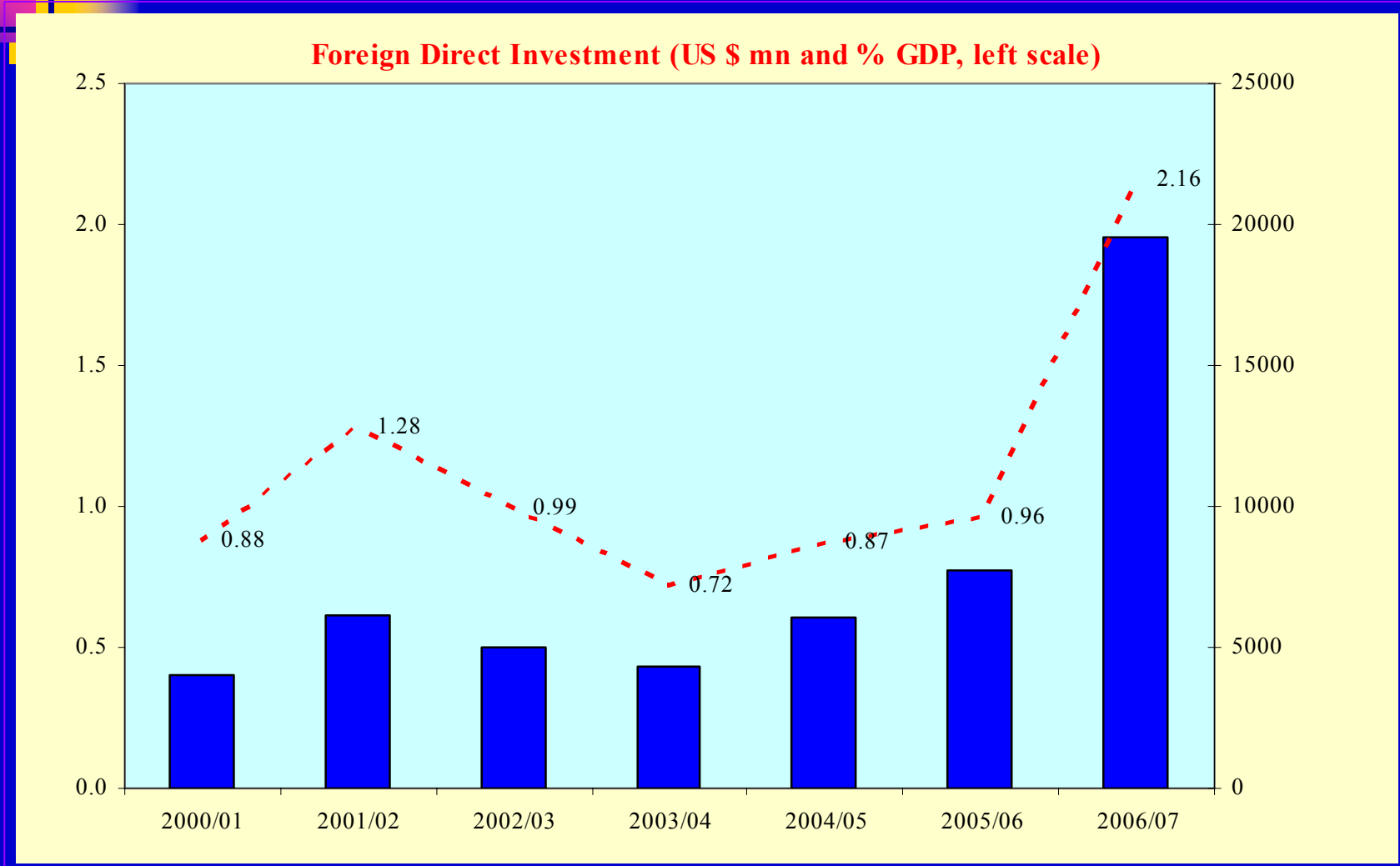
Marked improvements in investments in recent times

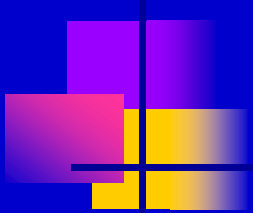
Data are on calendar year basis

Financed by a sharp increase in domestic saving

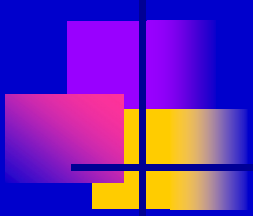


Also, for the first time, FDI has started to pour into India





- What about the claim that India is still not very integrated with the rest of the world?

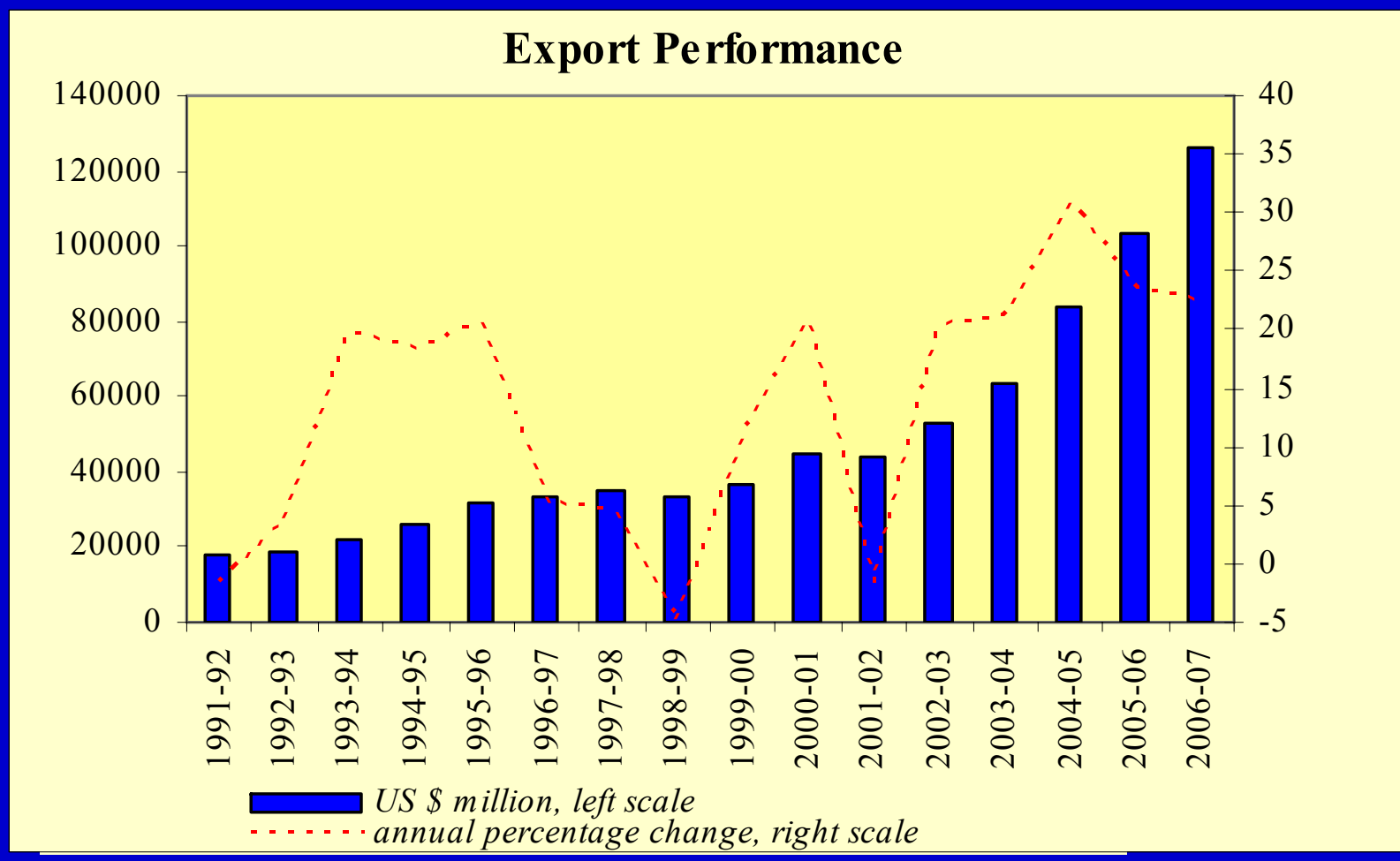


- Wrong again!

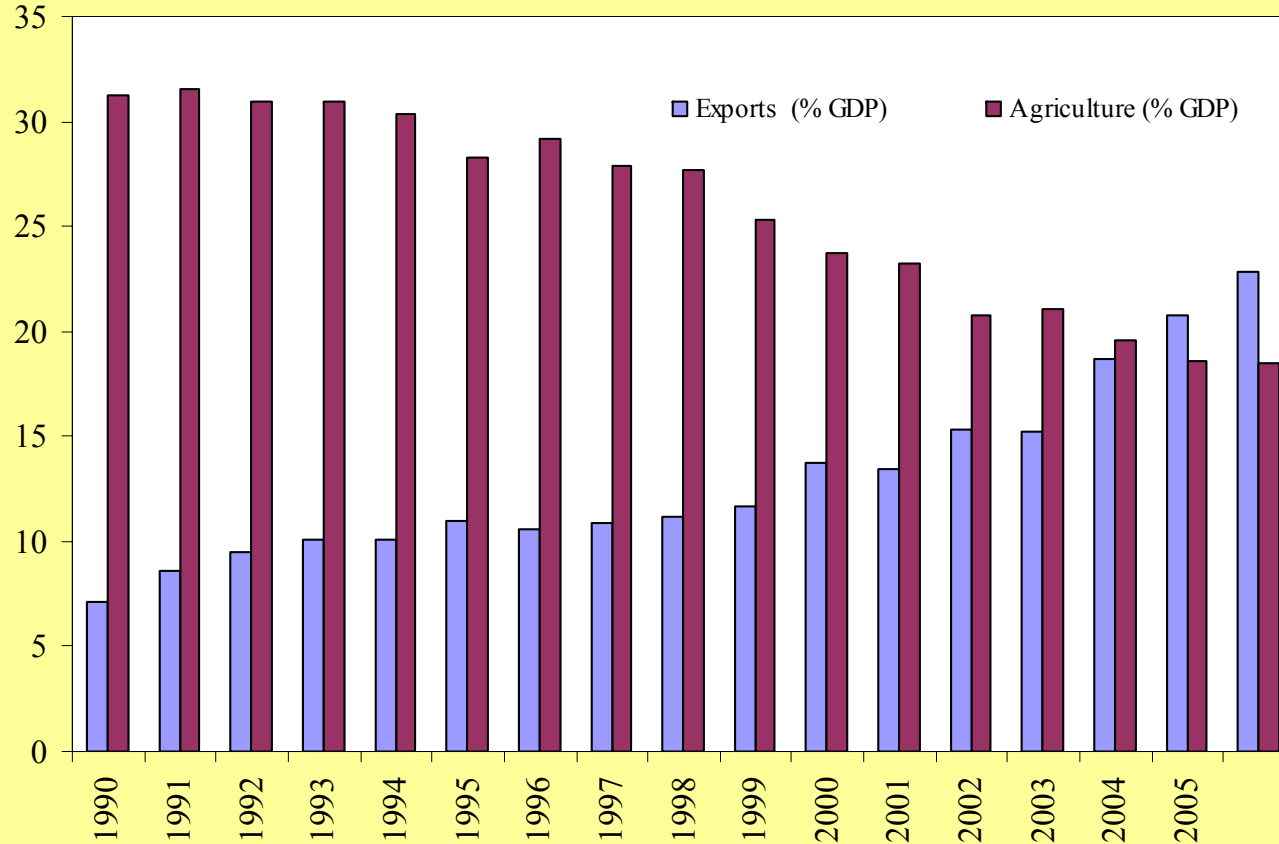
The investment boom has boosted productivity...



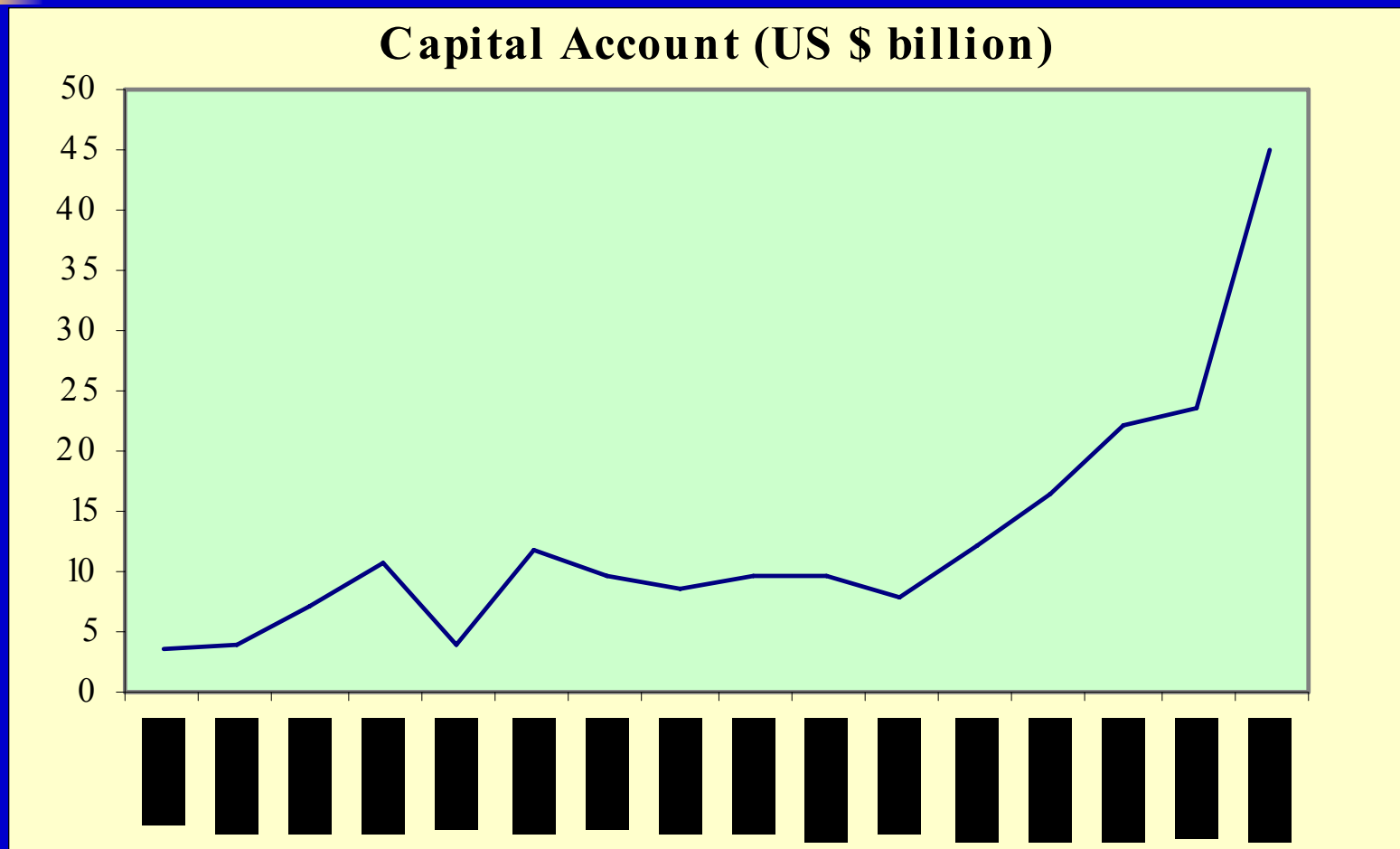
...making India internationally competitive



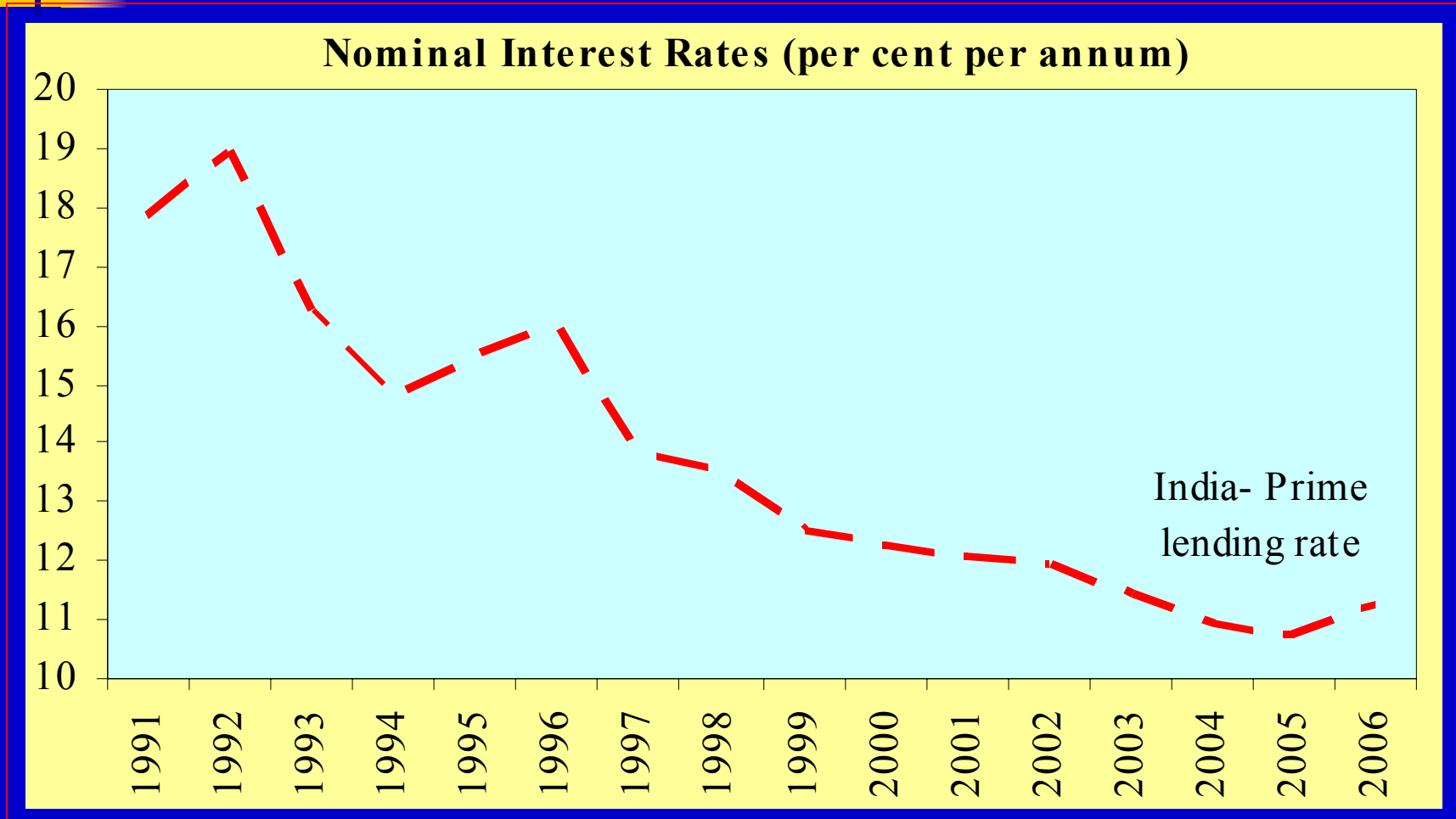
Exports are becoming more important than agriculture

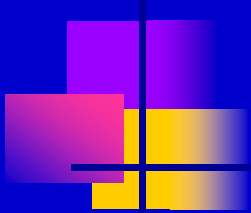


High profitability is also attracting capital inflows...



...leading to lower interest rates, further boosting profitability

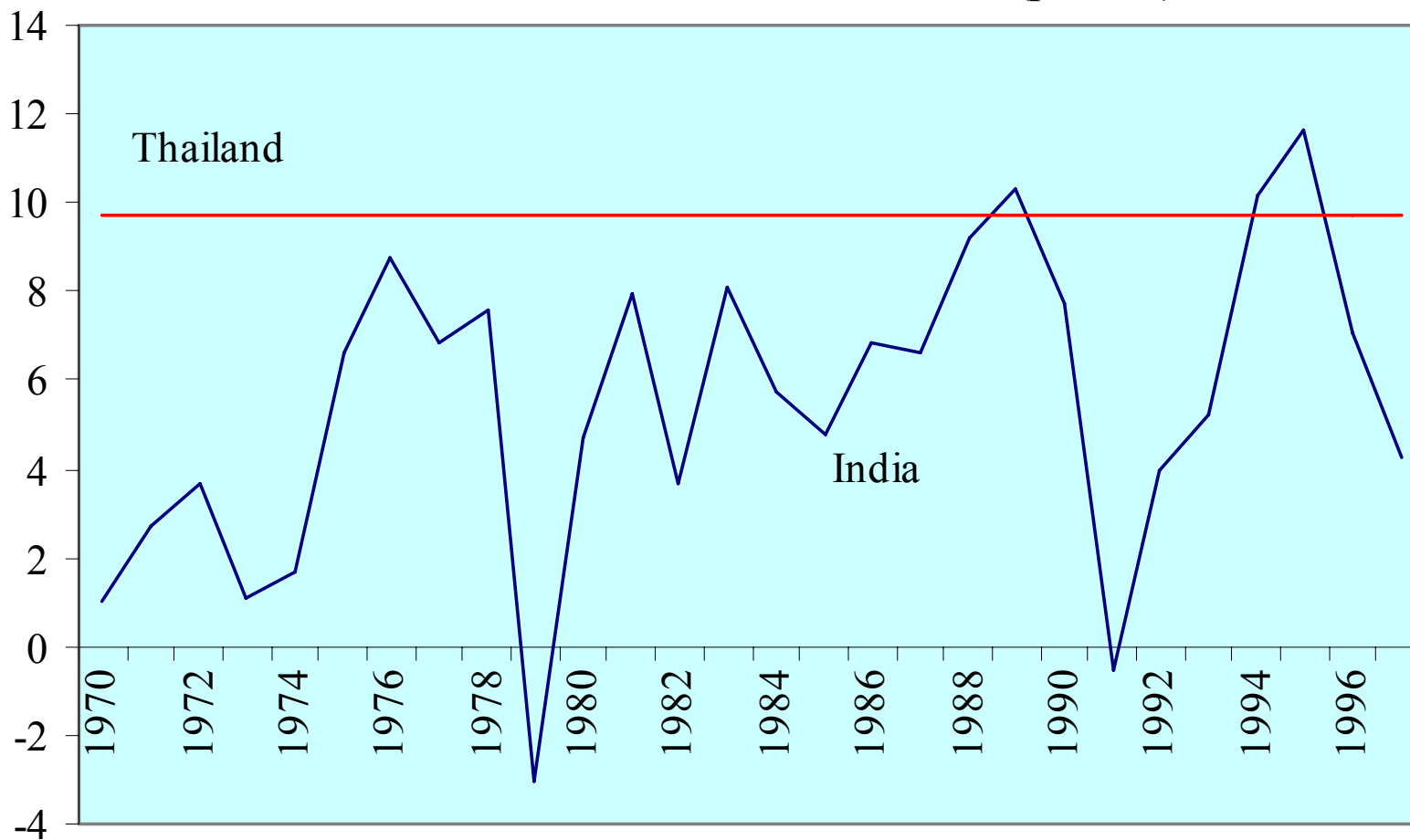




- What about manufacturing?

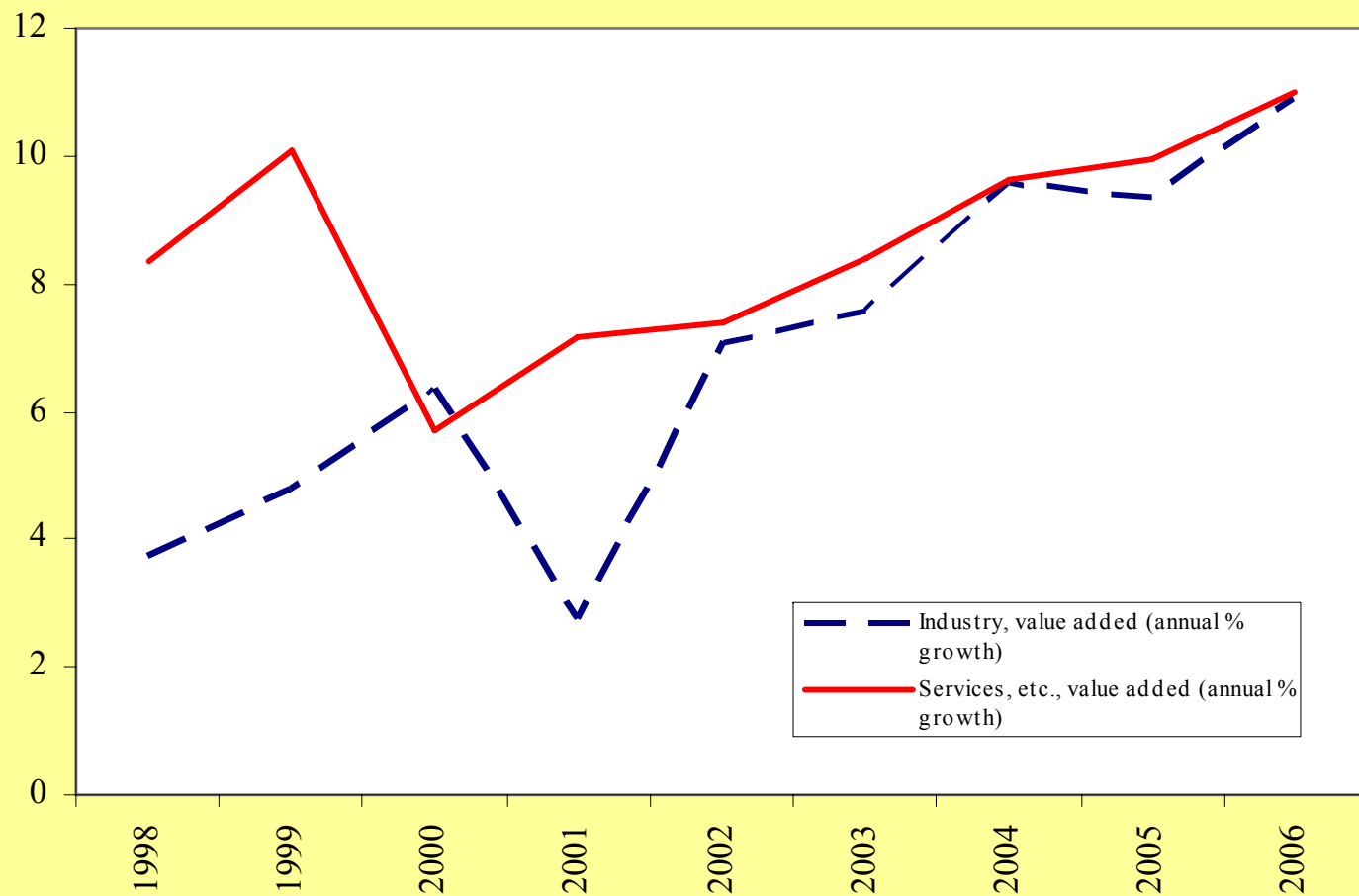
Unlike other Asian countries, India has never had a decade of 8 percent industrial growth

India and Thailand: Industrial Growth rates (percent)



But industry has accelerated sharply and is now growing about as fast as services!

Industry and Services (annual % growth)

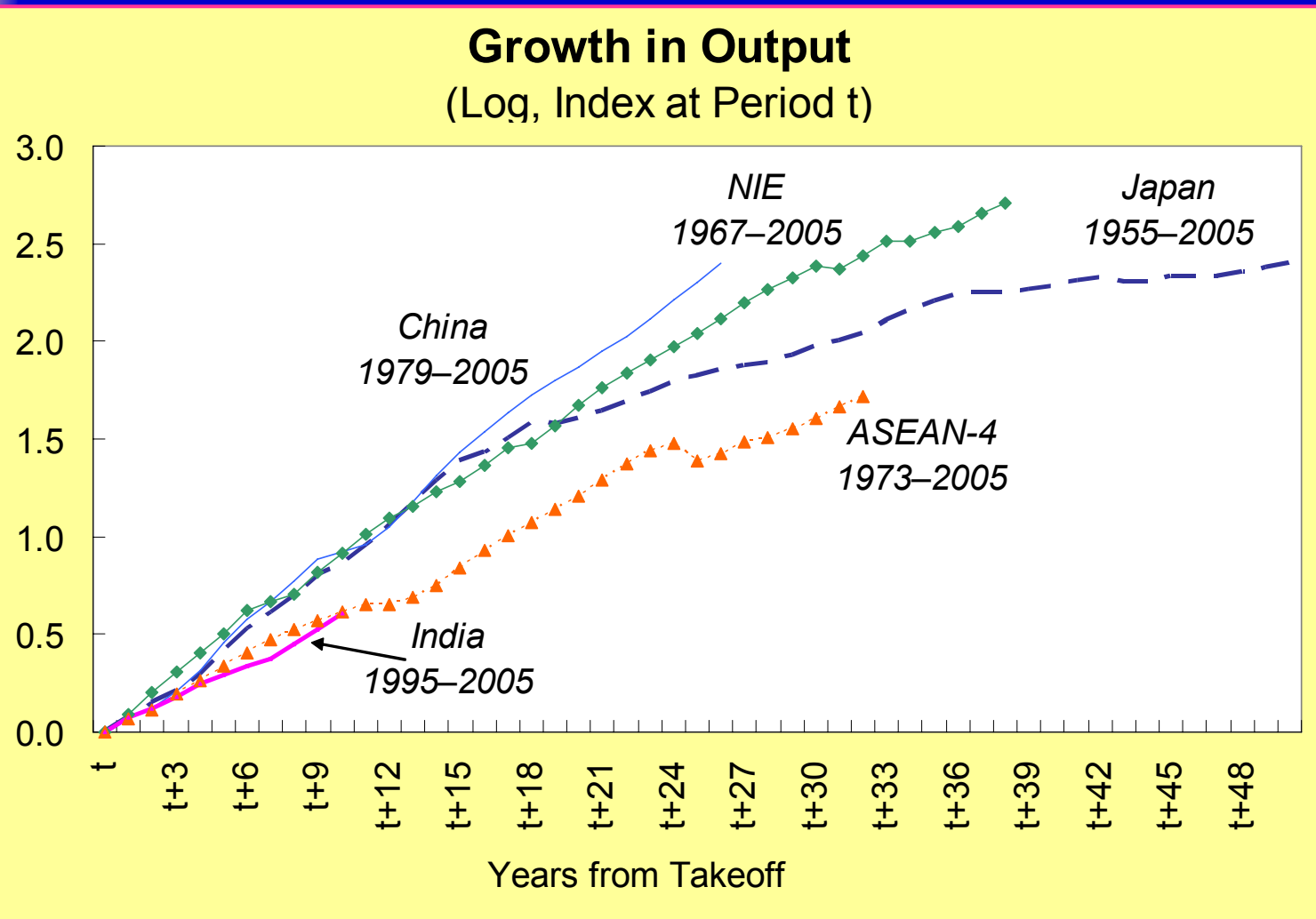




The story so far...

- Liberalization has created a framework where economic activity is now highly profitable
- As a result:
 - Investment and savings have jumped to East Asian levels; FDI is skyrocketing
 - Exports have been soaring
 - The manufacturing sector is growing at East Asian rates

India finally seems to be taking off!





Lifting millions out of poverty

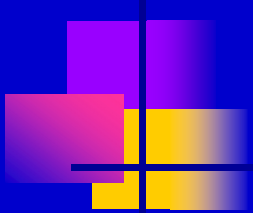
India: Evolution of Poverty

	Poverty Rate 1/			Poverty Gap 2/		
	All India	Rural	Urban	All India	Rural	Urban
1983	45.2%	46.2%	42.1%	12.6%	13.0%	11.5%
1987/88	39.3%	39.3%	39.2%	9.6%	9.4%	10.4%
1993/94	35.8%	36.8%	32.8%	8.4%	8.4%	8.3%
2004/05	27.5%	28.0%	25.8%	5.7%	5.5%	6.2%

Source: NSSO various rounds and Fund staff estimates.

1/ Defined as the share of the population below the poverty line.

2/ Defined as the amount that would bring all the poor to the poverty line as a share of the poverty line.



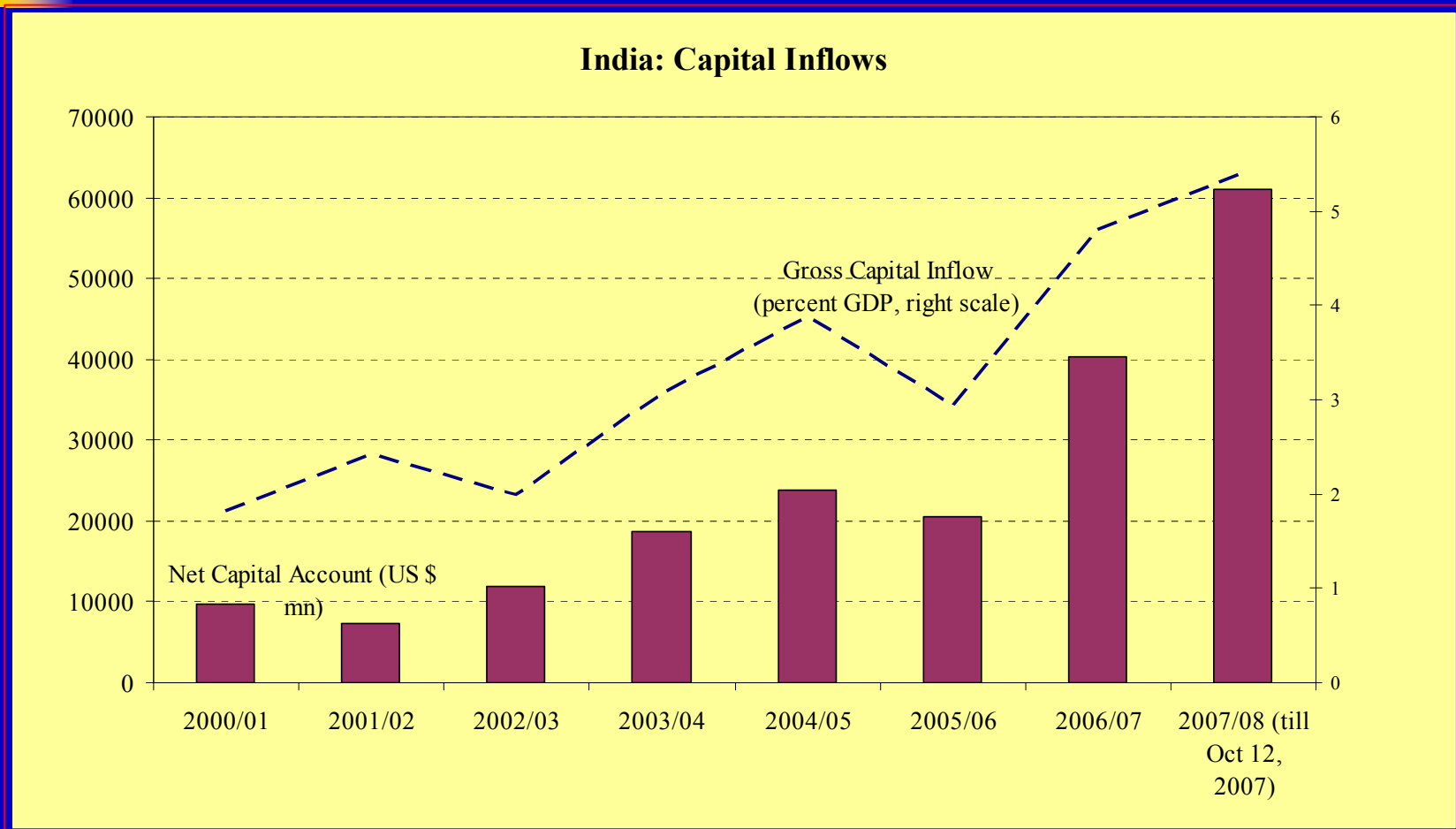
- But success brings its own challenges
- Let's look at two of them



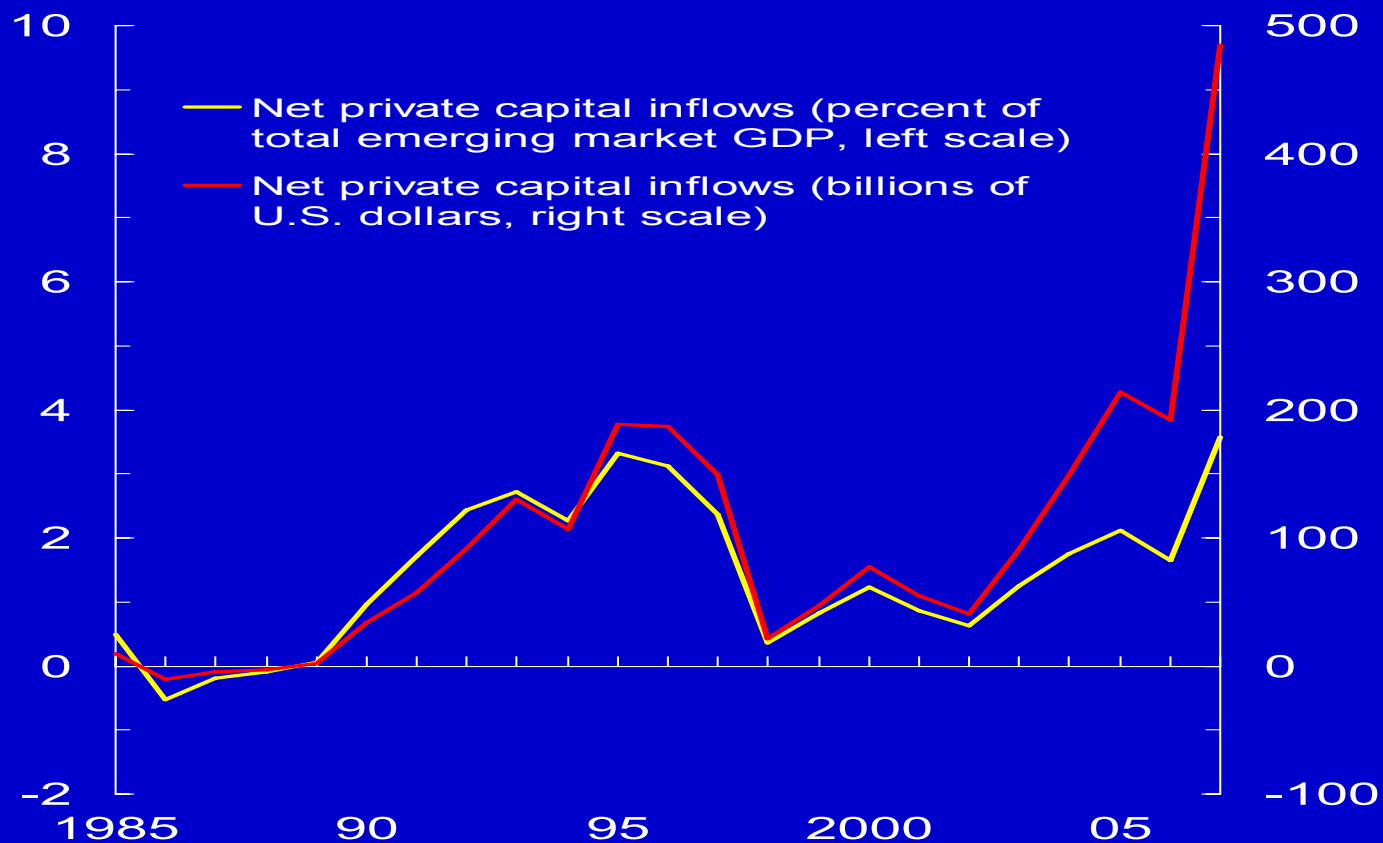
Roadmap of presentation

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- Can India manage its capital inflows?
- Can India kill the Bangalore bug?

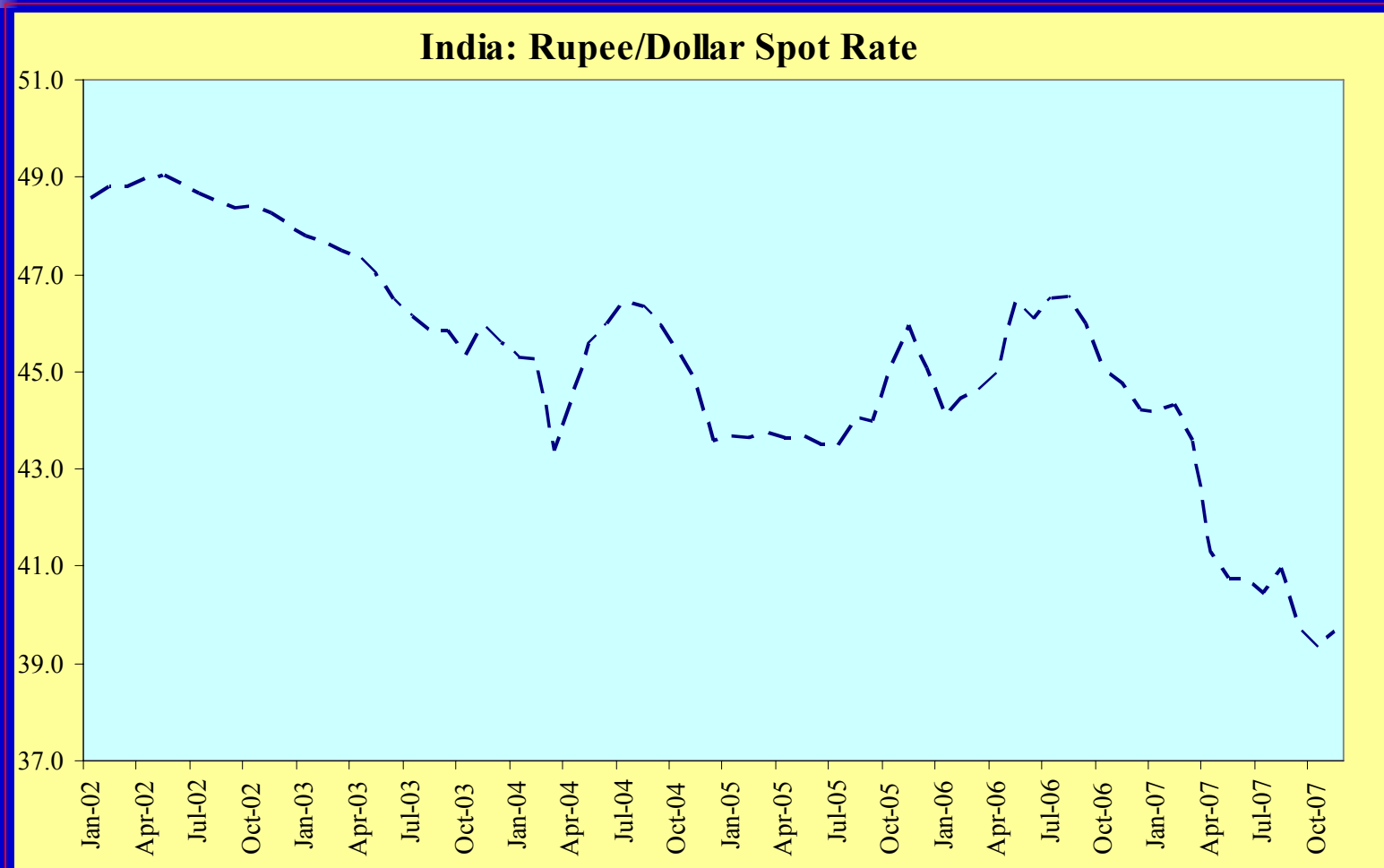
Capital inflows now exceed 5 percent of GDP...



...higher than the emerging market average

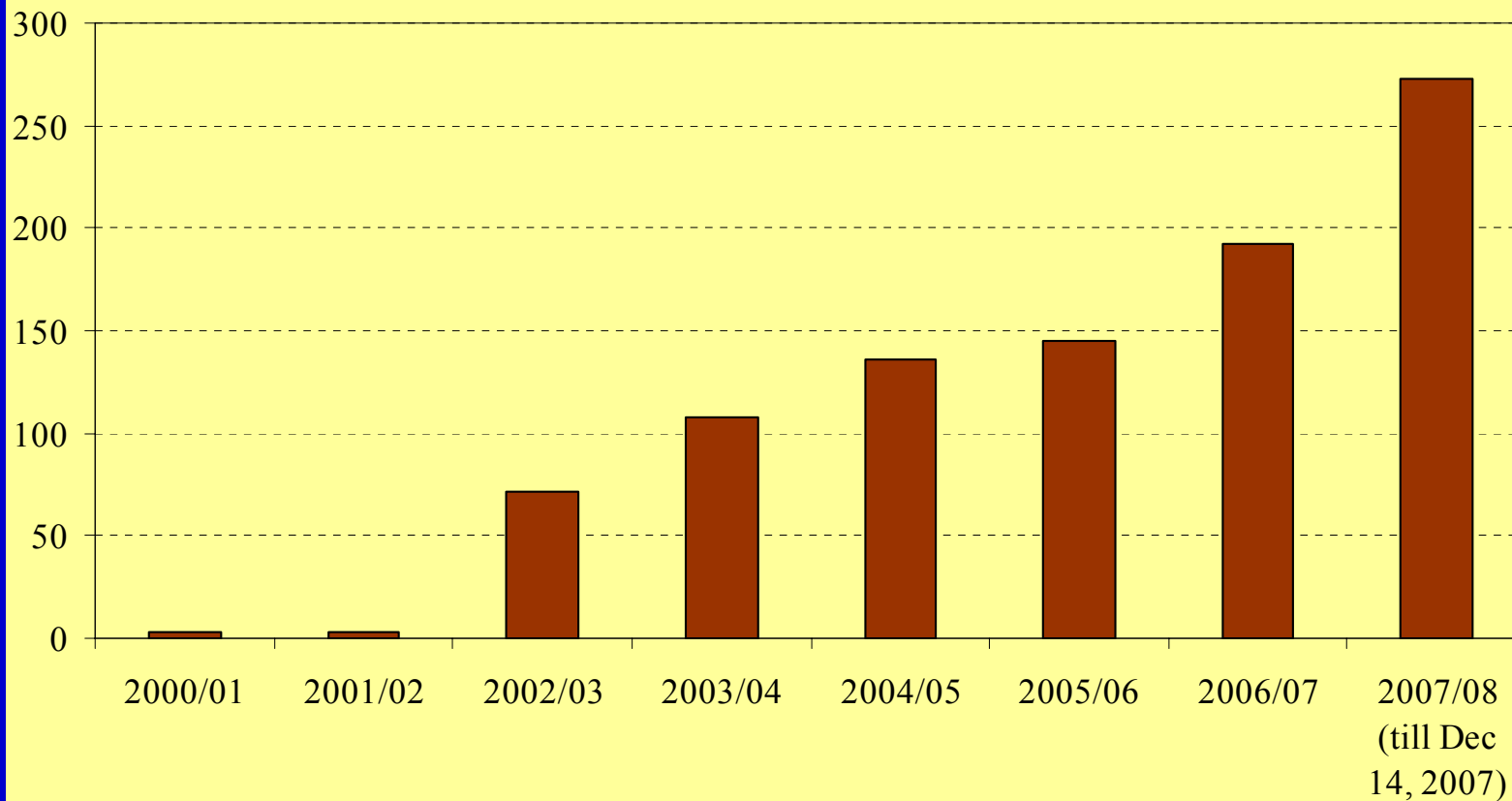


The authorities have responded
by allowing some appreciation...

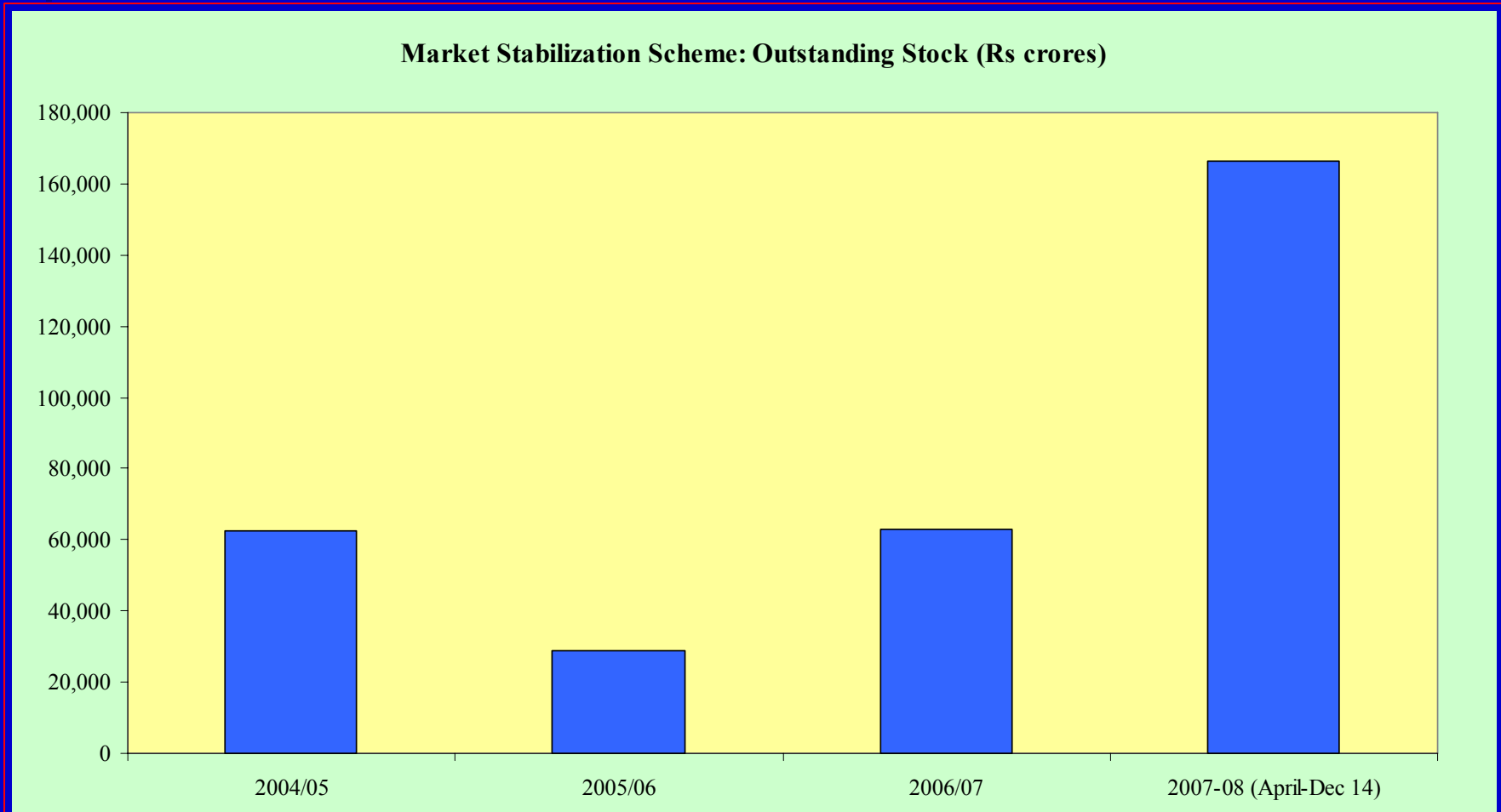


...but worried about competitiveness,
they have also intervened

India: Foreign Exchange Reserves (US \$ bn)

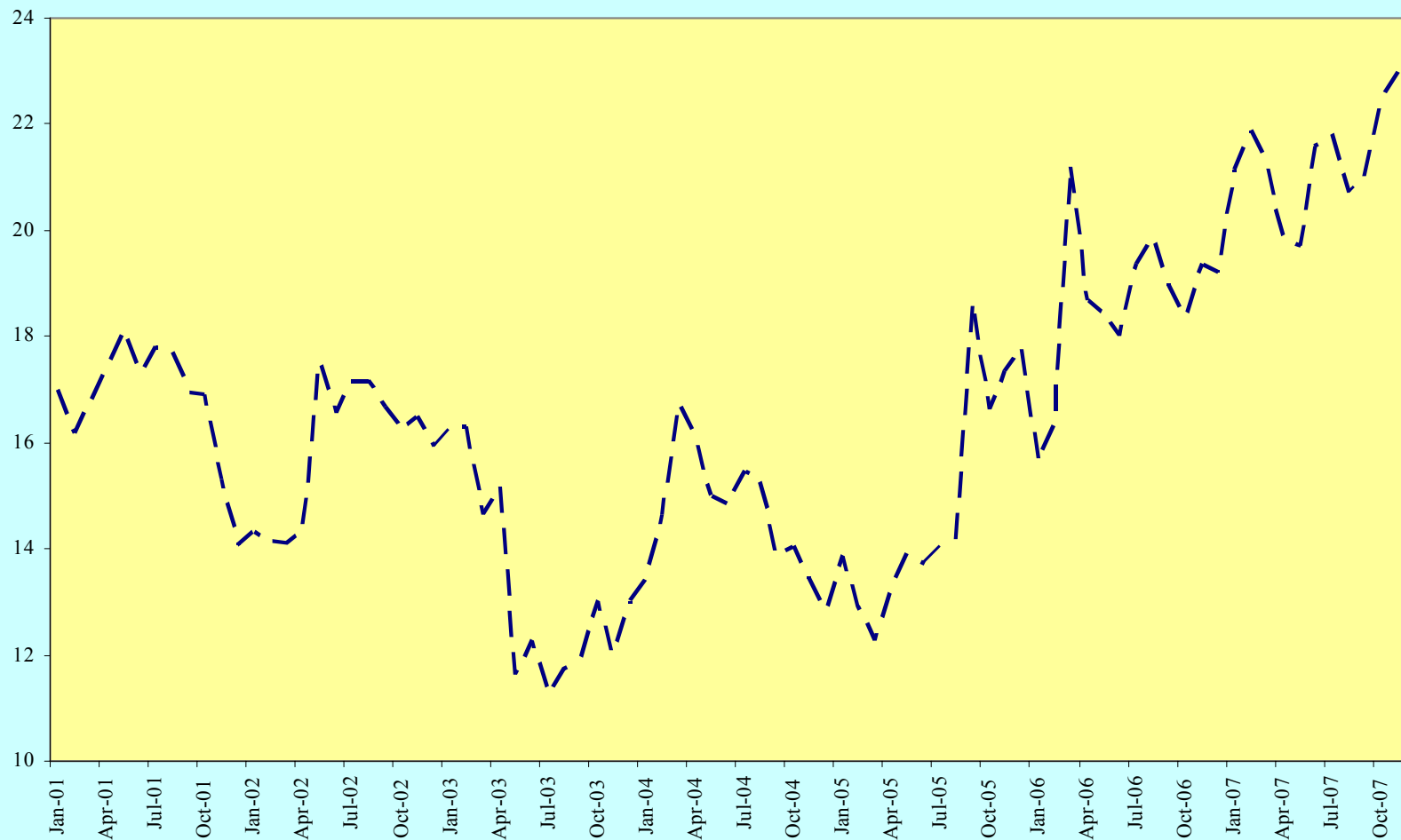


Most of the resulting liquidity injections have been “sterilized”...



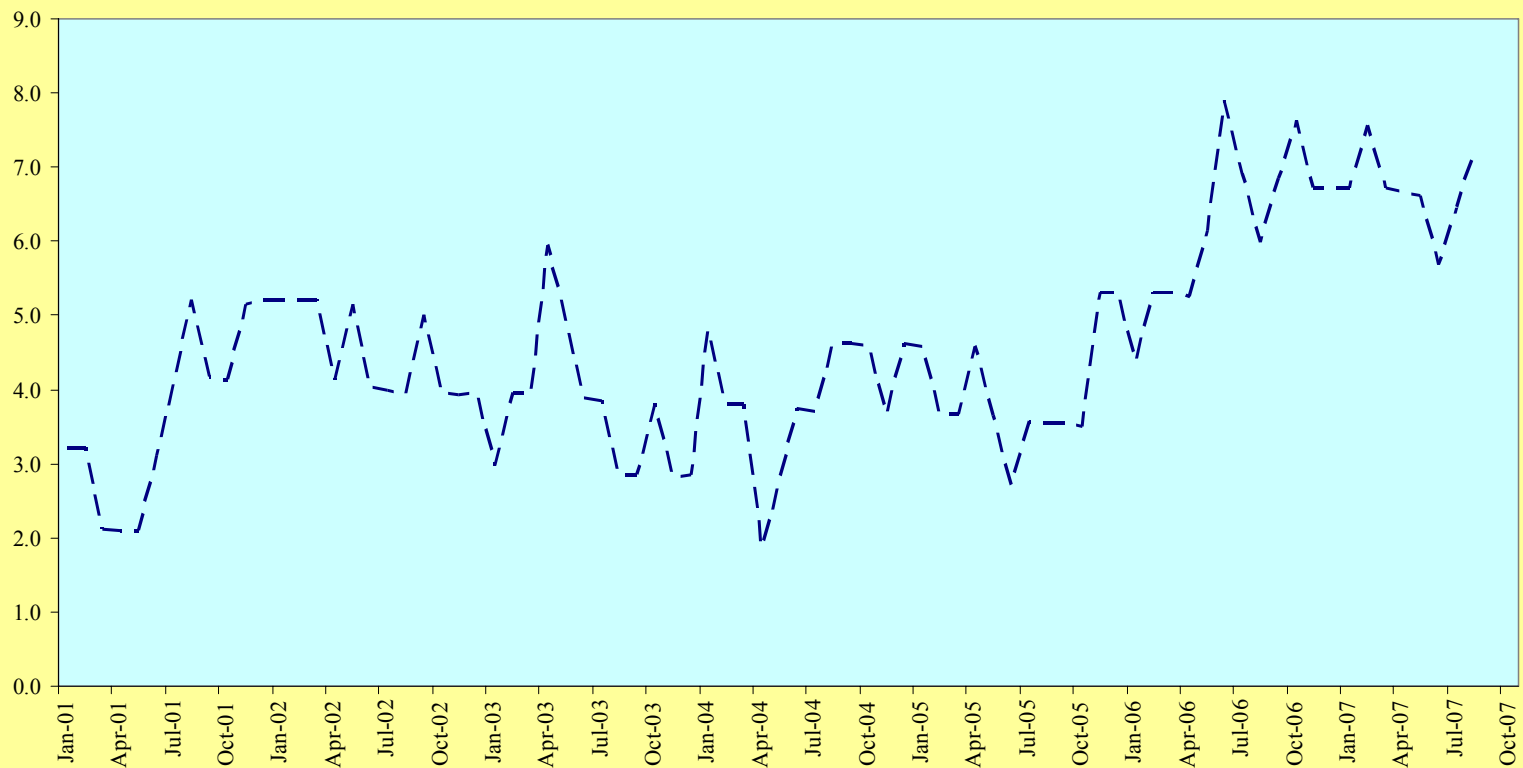
...but money supply growth remains rapid...

Broad Money (y/y percentage change)



...and CPI inflation stubbornly high

India: CPI Inflation (2001=100)





So, some controls have been imposed

- External commercial borrowing above \$20 million is now allowed only for the foreign exchange component of projects
- The securities regulator SEBI has restricted participatory note (p-note) investments in the stock market



The nub of the problem

- Some have suggested taxing capital inflows
 - Chile tried this in the 1990s, but abandoned it after finding that it didn't have much impact on overall flows
- Partial controls will not make a major difference to overall inflows
- Comprehensive controls would derail growth
- Which means the authorities are in a quandary!



Roadmap of presentation

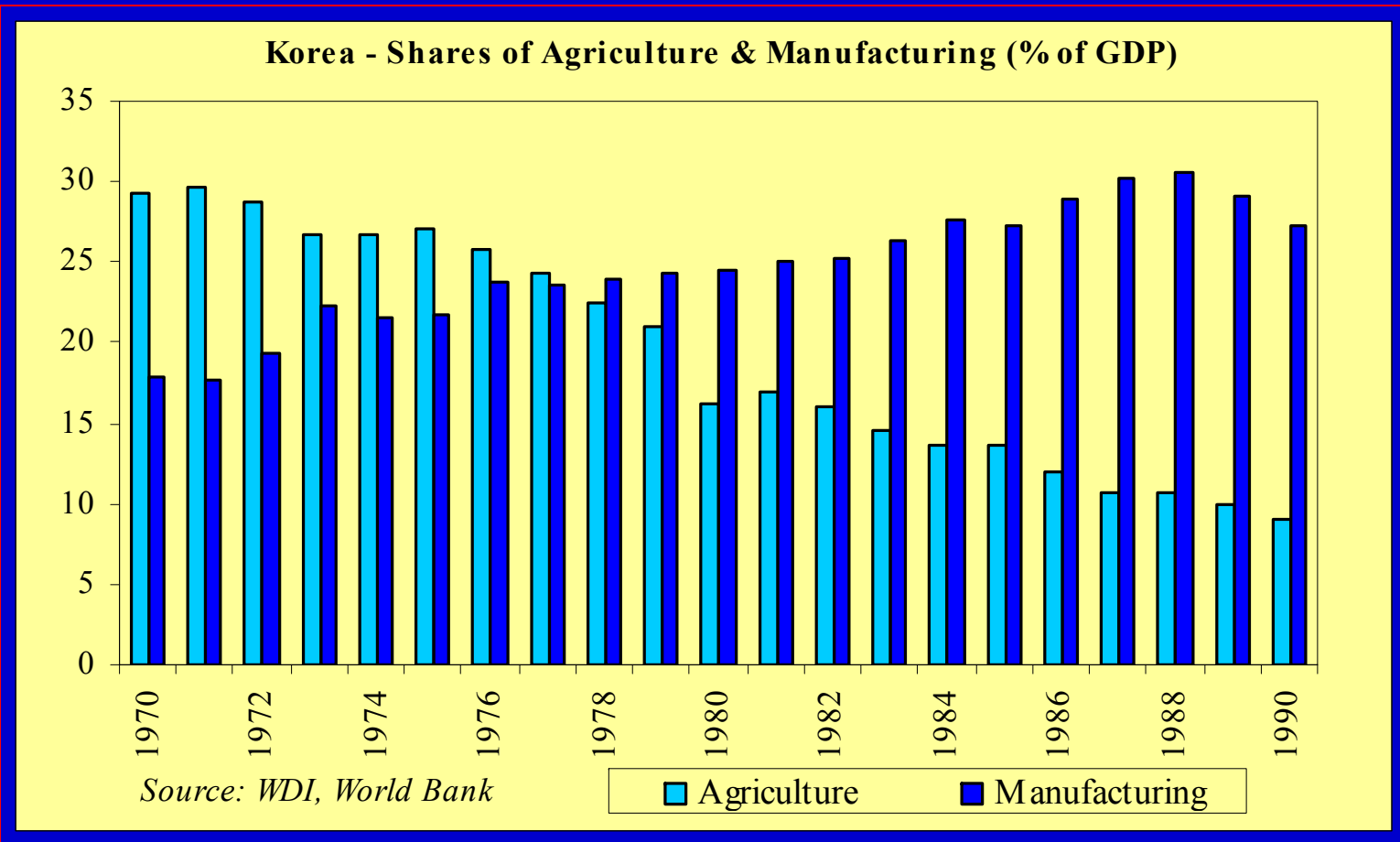
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Let's go back to the issue of India's growth path

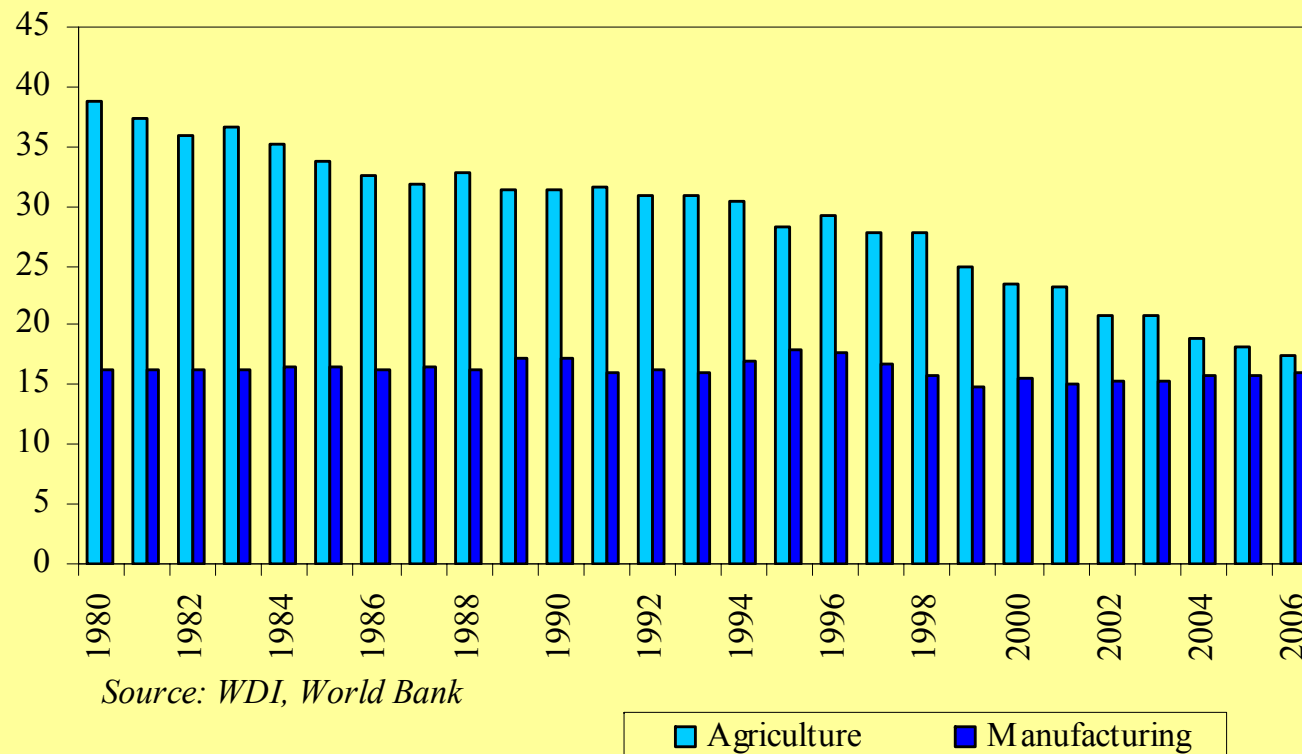
- There is one way in which India's path is strikingly different from that of other countries
- The standard route to prosperity in Asia has been:
 - Start with low-skill manufactured products, such as textiles and footwear
 - Export them
 - Then gradually move up the quality ladder

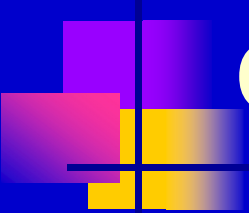
Korea's transformation



How does India compare?

India - Shares of Agriculture & Manufacturing (% of GDP)

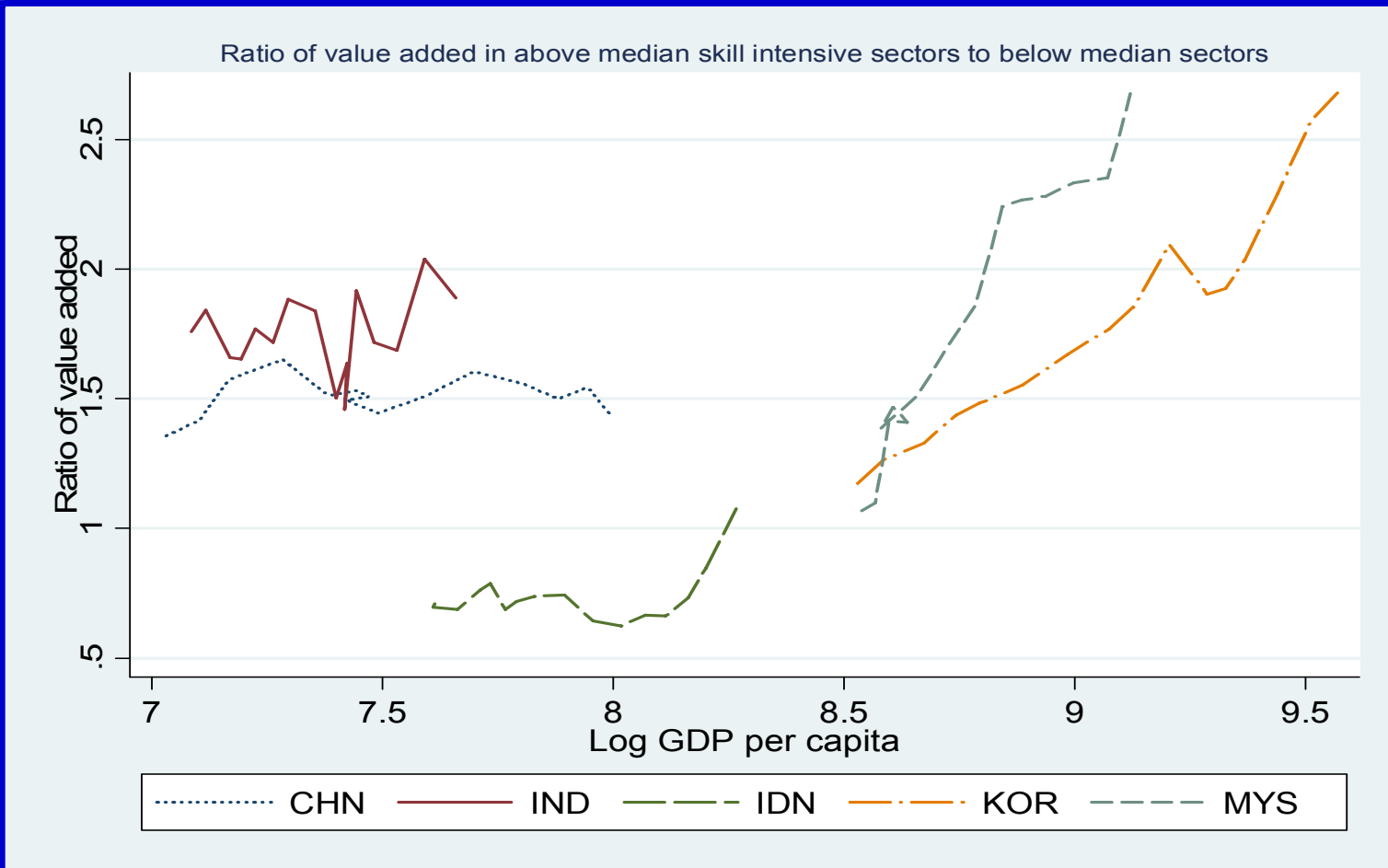




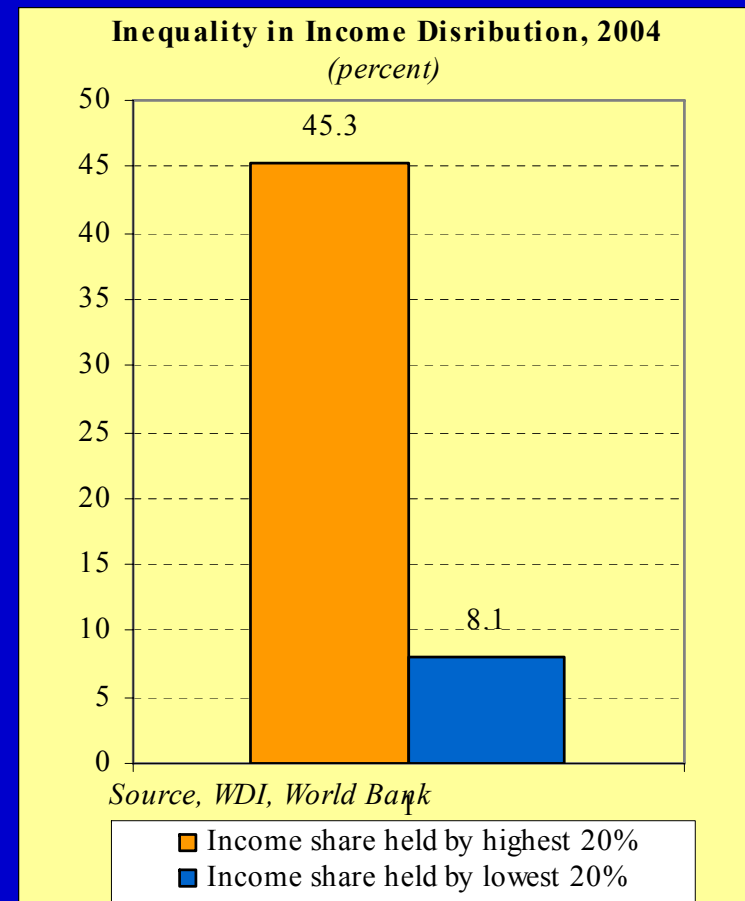
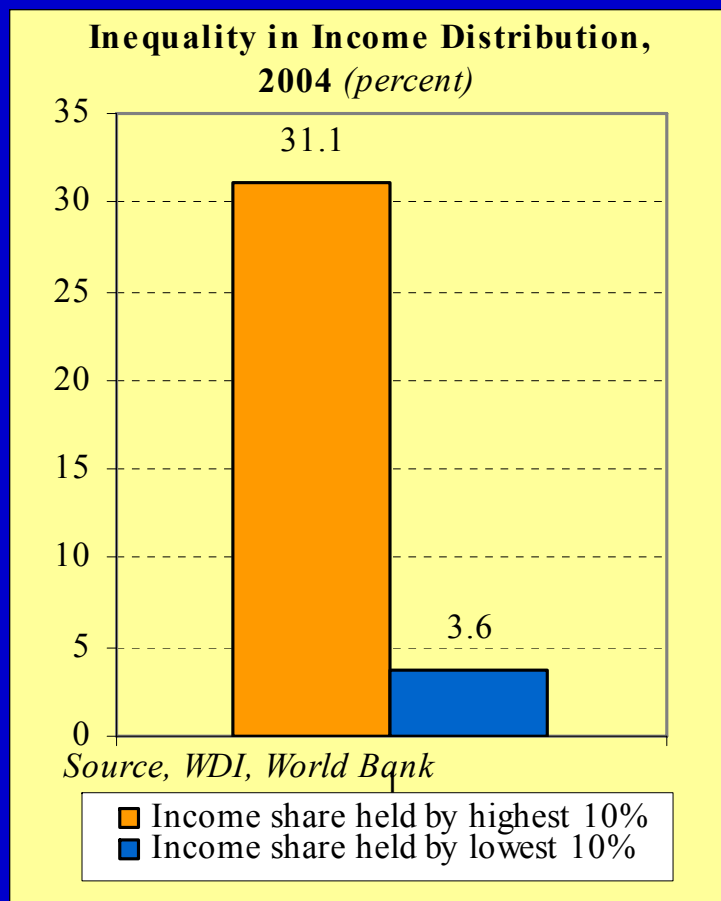
India's growth has been based on high-skilled labor

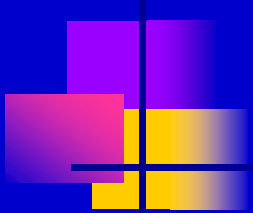
- The IT/ITES boom has depended on high-skilled workers
- Work at the IMF has demonstrated that even within manufacturing India has specialized in:
 - Large-scale industries, e.g. steel and chemicals
 - Skill-intensive manufacturing

Value added Share by Skill Intensity



But this is threatening a skills shortage and a polarization problem





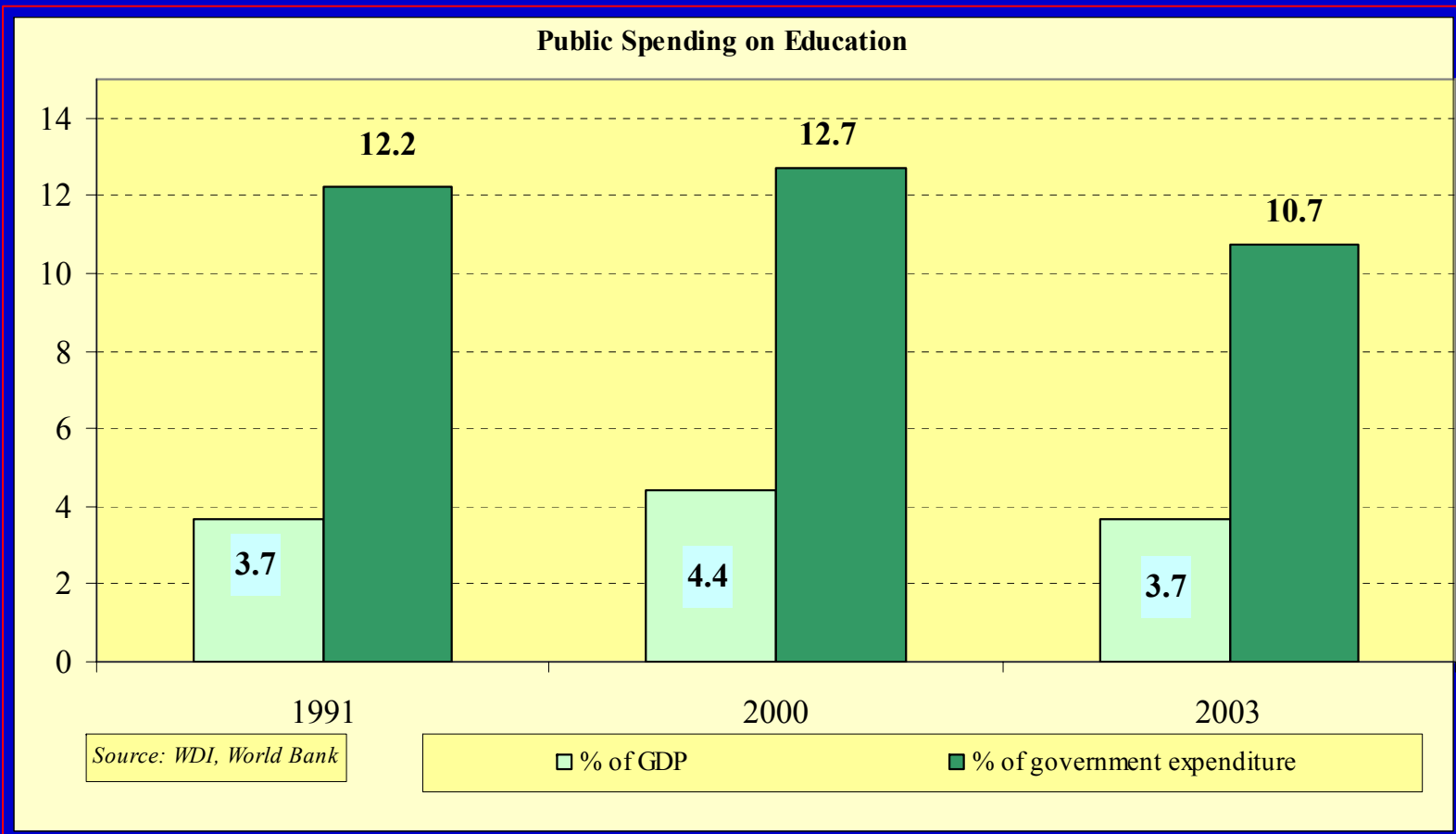
- Rajan et al have called this problem the “Bangalore Bug”
- How can this bug be killed?



Task 1

- Create opportunity for more people to acquire skills
- Particularly important because modern technology has a skills bias

Government needs to increase spending on education...





Reallocate spending...

- The reliance on skilled labor reflects India's emphasis on higher education
 - In 2000, India spent 86 percent of per capita GDP on each student in tertiary education
 - But only 14 percent of per capita GDP for primary students



...and make it more effective

- A recent study found that 38% of the children who have completed four years of schooling cannot read a small paragraph with short sentences meant to be read by a student of Class II
 - Elementary Education in India, Analytical Report (NIEPA 2006)
- About 55% of such children cannot divide a three digit number by a one digit number.



Task 2

- But even if education is improved dramatically, India will still have an exceptionally large pool of unskilled labor
- It will be important to encourage firms to hire such workers



The missing reform!

- India's labor regulations are unusually complex.
 - There are 47 national laws and 157 state regulations that directly affect labor markets. These are often inconsistent and at times overlapping.
- Industrial Disputes Act (IDA, 1982) made it compulsory for firms with 100 or more workers to seek state government permission to dismiss workers
 - India scores 70 out of 100 on the difficulty of firing index, relative to the regional averages of 38 in South Asia, 20 in East Asia and 27 for OECD countries
 - Currently about 533,000 labor disputes are pending, 28,000 of them for more than 10 years



Why do labor laws matter?

- These provisions discourage employment and are especially restrictive for labor-intensive sectors like textiles
 - Labor regulation creates adjustment costs:
 - In hiring and firing
 - In adjusting production.
 - So, firms will substitute away from labor toward other labor saving inputs
 - Labor regulation is the main reason why India's formal sector is so small
 - Because unregistered firms are not subject to the IDA



A natural experiment

- Labor regulations differ from state to state
- This has allowed economists to test the impact of different labor regimes within India
- Besley & Burgess (2004) find that the tougher a state's labor laws:
 - The poorer the performance of the registered manufacturing sector
 - Lower levels of investment, employment, productivity, and output
 - The larger the informal sector.



Conclusion

- India is in the process of taking off
- But it still faces two major challenges
- Macroeconomic: it needs to find a way to manage the capital that is flowing into the country, attracted by India's growth and profitability
- Microeconomic: it needs to create opportunities for all its people to participate in the boom, which will require educational and labor market reform
- Only then will India truly take off!

