London School of Economics

Address by

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January 29, 2007

<u>India : The Land of Growth Opportunities</u>

Ladies and Gentlemen,

In the eyes of Indian scholars, the London School of Economics, or the LSE, ranks along with Oxford and Cambridge as a great institution of learning. It is an institution that many aspire to join, but few succeed in doing so. LSE is the cherished *alma mater* of several economists, social scientists, constitutional experts, civil servants and statesmen who, after graduation, moved on to build distinguished careers in diverse fields. Indians who passed through the portals of LSE have made remarkable contributions to the building of modern India. An outstanding Indian scholar and administrator, Dr. I.G Patel has repaid our debt in part measure, and we are naturally proud that he guided this institution for some years. It

is, therefore, with a deep sense of gratitude that I accepted the kind invitation extended by your Director, Mr. Howard Davies, to deliver a talk this afternoon.

2. I am not a remarkable storyteller, but I have a remarkable story to tell. The story begins in 1991. In recent years, the story has got better. As you may have guessed, it is the story of India's economic reforms.

3. After recording insipid growth rates of GDP (at factor cost) in the first 30 years, followed by an improvement in the eighties to an average of 5.6 per cent, India made a decisive shift beginning June 1991. In the nine years ending 1999-2000 the average annual growth rate of GDP was 5.8 per cent. More than the growth rate, what was important was the change in the paradigm. It was not easy to bring about that change. Every measure faced resistance. When the economy faltered, as it did in 1997-98, thanks to the Asian crisis, or in 2002-03, due to widespread drought conditions, the critics were quick to blame the reform process. Nevertheless, we have persevered on the path of reforms: the Indian economy is more open today; trade volumes and trade intensity have increased; capital flows are more copious; and India's industry and services sectors have acquired a competitive edge that was absent a mere 15 years ago.

4. Since the turn of the new century, we seem to have made a fresh beginning. Although growth rates were moderate in the first

three years, there has been a sharp rise since 2003-04. In the three years from 2003-04 to 2005-06, the average annual growth rate of GDP has been 8.1 per cent. Initially, this was thought to be a cyclical upturn. However, more observers and analysts are now inclined to think that there has been a structural shift and the Indian economy is now on a higher growth path.

5. The current year, 2006-07, has been good so far. The first half has registered a growth rate of 9.1 per cent, with the second quarter registering 9.2 per cent. I am reassured by the indicators available to us that growth in the second half of the current fiscal will also be close to 9 per cent. If these indicators turn out to be correct, the GDP growth rate for the current year will be the highest since reforms were initiated in 1991. The International Monetary Fund (IMF) seems to share this assessment.

6. We have looked closely at the reasons behind the new growth trend. The momentum in 2003-04 was provided by 'agriculture'. That sector grew by 9.6 per cent, bouncing from a low of -5.6 per cent in the previous year which was severely affected by drought. In the subsequent two years, the momentum was provided by a remarkable expansion in the 'industry' and the 'services' sectors. In 2004-05 and 2005-06, 'industry' grew by 8.6 per cent and 9.0 per cent while 'services' grew by 9.9 per cent and 9.8 per cent respectively. That momentum continues in 2006-07. Within the 'industry' sector, it is manufacturing which is driving growth. After recording growth rates of

8.1 per cent and 9.0 per cent in the last two years, manufacturing has grown at 11.6 per cent in the first half of the current fiscal.

7. Until some time ago, it was believed that consumption was driving growth. However, it is increasingly clear that not only consumption but investment is also driving growth. The estimate of gross domestic savings in 2004-05 was 29.1 per cent of GDP and the rate of gross capital formation was 30.1 per cent of GDP. That year recorded a GDP growth rate of 7.5 per cent. If the growth rate has accelerated to nearly 9 per cent in the current year, it is axiomatic that, even allowing for gains in productivity, both the savings rate and the investment rate should have moved upward. While firm figures are not yet available, it is our view that the current investment rate is perhaps close to 35 per cent of GDP.

8. It is our intention to maintain the growth momentum witnessed in the last four years. To that end, we have taken a number of decisions. Foremost among the decisions is the need to observe fiscal prudence and discipline. Soon after the UPA government took office, the Fiscal Responsibility and Budget Management (FRBM) Act was notified. The Act obliges the government to eliminate the revenue deficit by 2008-09 and to contain the fiscal deficit at 3 per cent or below by that year. I am confident that we will meet the targets set for ourselves for the current year as well as make every effort to achieve the final targets prescribed in the FRBM Act.

9. What does this mean? It means that, beginning April 2009, the total public sector borrowing of the government, not exceeding 3 per cent of GDP, would be used for capital expenditure. Add to that the portion of tax and non-tax revenues that is normally earmarked for capital expenditure. Add to that the amount of capital investment that will be made by the private sector. We have every reason to believe that India is poised to witness an investment boom that will take the Indian economy to an even higher growth path.

10. The challenges that we face are indeed numerous. The most formidable challenge is in the agriculture sector. The average operational land holding of a farmer is small (about 3.5 acres). Most agricultural land (up to 64 per cent) does not have assured irrigation. Over one-half of farm households do not get institutional credit and are dependent upon money lenders. Water is scarce and, every year, some part of the country is affected by drought. Public investment in agriculture has remained low. Agricultural growth in the six years since 1999-2000 has averaged 2.17 per cent. This is a deceleration from the average rate of 4.68 per cent witnessed in the eighties and 3.16 per cent witnessed in the nineties. While a number of corrective steps have been taken in the last three years, the time has come to make a determined and decisive intervention in agriculture in order to boost production and productivity.

11. Low farm incomes have pushed many farmers into crippling debt. It is vital to increase agricultural incomes because nearly 60 per

cent of the workforce is dependent on agriculture. Higher agricultural output is also critical for ensuring food security. A multi-pronged strategy has been devised that includes rapid expansion of irrigation facilities, extension of credit, introduction of new technologies, offering remunerative prices for farm produce and supplementing farm income with incomes from allied activities such as dairy, inland fisheries, poultry and animal husbandry.

12. Another important challenge is in human resources. No doubt, we have a large population. No doubt, the size of our working age population will continue to grow until the year 2040 and we will enjoy a demographic advantage until that year. Nevertheless, it has been estimated that we will face a severe shortage of skilled workers unless we expand capacity and improve quality in our schools, colleges and vocational training institutions. While the Gross Enrolment Ratio (GER) of children in the age group 6-14 years has improved to 85 per cent, 52 per cent of children enrolled in school drop out by the time they enter class 6, and this number deteriorates to 80 per cent by the time they enter class 11. There is also the question of health and nutrition. 47 per cent of children under three are underweight. There is also the further question of gender inequality.

13. At the other end, post-school education in India is still a distant dream for many school-leaving students. No more than 17 million have received tertiary education in India with a population of 1.12

billion. The enrolment ratio in tertiary education in India is about 9 per cent. In many developed countries this ratio is in excess of 60 per cent. A huge distance has to be covered before it can be said that we are capable of fully exploiting the abundant human resources available in India. Unless we do this, we will be faced with a severe shortage of teachers, scientists, doctors, engineers, accountants and other professionals. We are, therefore, in the process of expanding capacity in all institutions of higher education by 50 per cent over the next three years. We are conscious that while we add to the quantity we must also pay attention to quality.

14. There are other challenges. I do not have the time to dwell on them in great detail. However, I would like to say that the approach document to the 11th Five Year Plan, which will commence on 1st April 2007, has identified these challenges and has outlined the measures to overcome them. The goal of the 11th Plan is 'faster and more inclusive growth'. Growth and equity, in our view, are inseparable. Growth is the best antidote to poverty. It is growth which will throw up more revenues to the State, more jobs to the workforce and more incomes to the employed. It is growth which will open more opportunities to the entrepreneur and the innovator. While growth is an imperative in a developing country like India, we are conscious that the benefits of growth do not percolate quickly, or evenly, to those who are at the bottom of the pyramid. It is therefore necessary to address the concerns and needs of the very poor and the disadvantaged sections of society. The number that falls in this

group is not small: in a large country like India, this number is close to 250 million. India's poverty alleviation programmes have to be understood in the context and situation in which they have been designed. In this regard, I would like to make special mention of some interventions such as the National Rural Employment Guarantee Programme, the Integrated Child Development Scheme, the National Rural Health Mission, the Total Sanitation Programme and the Rural Electrification Programme. I would also like to say that we subsidize food for the poor, fuels used by the poor, fertilizers used by the farmer, and water and electricity used for agriculture. Absent these subsidies, an intolerable burden will be placed on the poor. While there is indeed a case for better targeting of subsidies and preventing leakages, as long as a large proportion of the population is poor, the Government has an obligation to allocate a significant part of the total resources to these subsidies.

15. Let me now turn to some more successful chapters of India's growth story. The process of reforms has spanned the real, monetary, financial, fiscal and external sectors. In the financial sector, we have put in place independent regulatory mechanisms. The Indian capital market is deep and robust and allows for the most advanced market procedures and instruments.

16. We also have a liberal policy regime for foreign direct investment (FDI). Except for a small negative list, FDI is mostly on the automatic route. India is a signatory to MIGA. India has also signed

bilateral investment protection agreements (BIPA) and double taxation avoidance agreements (DTAA) with a large number of countries. The Rupee is convertible on the current account and, as far as the foreign investor is concerned, it is also convertible on the capital account. Investments made in India are safe and secure, and both profits and capital can be repatriated. Above all, the investments are governed by the rule of law.

17. The fiscal side too has witnessed many reforms. Tax rates are stable and moderate. Customs duties have been brought down to nearly ASEAN levels. In 2005-06, State governments were persuaded to switch over to the value added tax (VAT). It was the most important tax reform undertaken in nearly 75 years. Buoyed by its success, we have announced our intention to introduce a nation-wide goods and services tax (GST) with effect from 1st April 2010. Tax reforms are a continuous exercise. It is our intention to improve compliance with the tax laws, moderate the tax rates and administer the tax code in a non-discriminatory and tax payer friendly manner.

18. On the trade front, we have recorded splendid performance. The peak rate of customs duty has been reduced to 12.5 per cent for non-agricultural products. There are few non-tariff barriers. Both imports and exports have steadily risen over the years. In 2005-06, exports amounted to US$ 103 billion. Trade intensity (counting both goods and services) is about 40 per cent of GDP. We have confidently entered into bilateral trade agreements and

comprehensive economic cooperation agreements with countries such as Thailand and Singapore. More agreements are under negotiation. At the same time, we remain focused on the larger goal of having a multi-lateral trade agreement under the WTO. Despite the setbacks witnessed in recent months, we are committed to work for a successful conclusion of the Doha round.

19. We are no longer dismayed by the size of our trade deficit. India is the largest recipient of remittances. In 2005-06, on net terms this amounted to nearly US$ 24 billion. In that year, net FII flows were US$ 9.9 billion and FDI inflows totaled US$ 7.9 billion. We have added to our foreign exchange reserves every year since 1991-92. The reserves now stand at US$ 178 billion as on January 19, 2007.

20. Until recently, it was believed that India's growth as well as India's success in the external sector were driven by the 'services' sector. That remains largely true, thanks to our software services, software exports and success in business process outsourcing (BPO). However, India has also emerged as a major hub for manufacturing and export of manufactured products. We are among the leading producers – and exporters -- of automobiles, automobile parts, leather goods, textiles, pharmaceuticals, petroleum products and machine tools. If you will add handicrafts and hand made products, flowers and herbs, spices and marine products, mangoes and Bollywood movies, you will agree with me that our engagement with the world is very broad-based and impressive.

21. A relatively new facet of India's globalization is the outward foreign direct investment by Indian companies. The outward investment in 2004-05 has been estimated at US$2.6 billion and in 2005-06 at US$ 2.7 billion. The numbers are perhaps small by world standards, but this is only a beginning. Indian companies have demonstrated their capacity to go abroad and acquire manufacturing firms and position themselves as serious players in many world markets. I may point out that the Global Competitiveness Report for 2007 gives high scores to India on capacity for innovation and sophistication of operations.

22. India has also emerged as a capable and dependable centre for research and development and is a source of new ideas in science and technology. Many of the world's largest corporations have established a research base in India.

23. The Achilles heel of India's growth story appears to be the physical infrastructure – roads, railway, airports, seaports, power and telecommunication. In a sense, the deficiencies have been exposed by the rapid rate of growth. We recognize the need to provide world class infrastructure in order to meet the requirements of a fast growing economy. We are therefore employing more than one model to build infrastructure on an ambitious scale. While the telecommunication sector is driven by private investment and railway is driven by public investment, we have adopted the public private

partnership (PPP) model to steer growth in the roads, airports, seaports and power sectors.

24. The resources required for infrastructure development are huge. Over the next five years, we would need about US$320 billion. The bulk of this amount will come from domestic resources. We are confident that we can attract adequate foreign investment into our infrastructure sectors. What is a challenge to India is an opportunity for the foreign investor. I dare say that there is no other country in the world, save perhaps China, which needs and which can absorb such large amounts of foreign investment in its infrastructure sector.

25. We are also conscious that the overarching requirement for success is good governance. We have the rule of law, but the rule of law does not always ensure good governance. It is the people who have to demand – and enforce – good governance. We see this happening in many States. However, differences between State and State in the quality of governance remain. Competition among States, connectivity, internal migration, expansion of the media, the new regulatory bodies and the recently passed Right to Information Act will, in course of time, contribute to better governance.

26. When he unfurled the Indian flag on 15th August 1947, Jawaharlal Nehru, India's first Prime Minister, recalled that, long years ago, India had made a tryst with destiny. In a few months from now, we will celebrate 60 years of attaining independence. These 60

years have been marked by success and failure, conflict and resolution, war and peace, hope and despair, and growth and stagnation. I believe that India has broken out of the circle of poverty and neglect. I believe that India has ended its isolation from the rest of the world. I believe that India has discovered its legitimate role and place in the world economy. I am confident that nothing can stop India from marching to its rightful status of an economic power that is committed to the development and prosperity of not only the Indian people but also the development and prosperity of the people of all countries of the world.

27. Thank you.