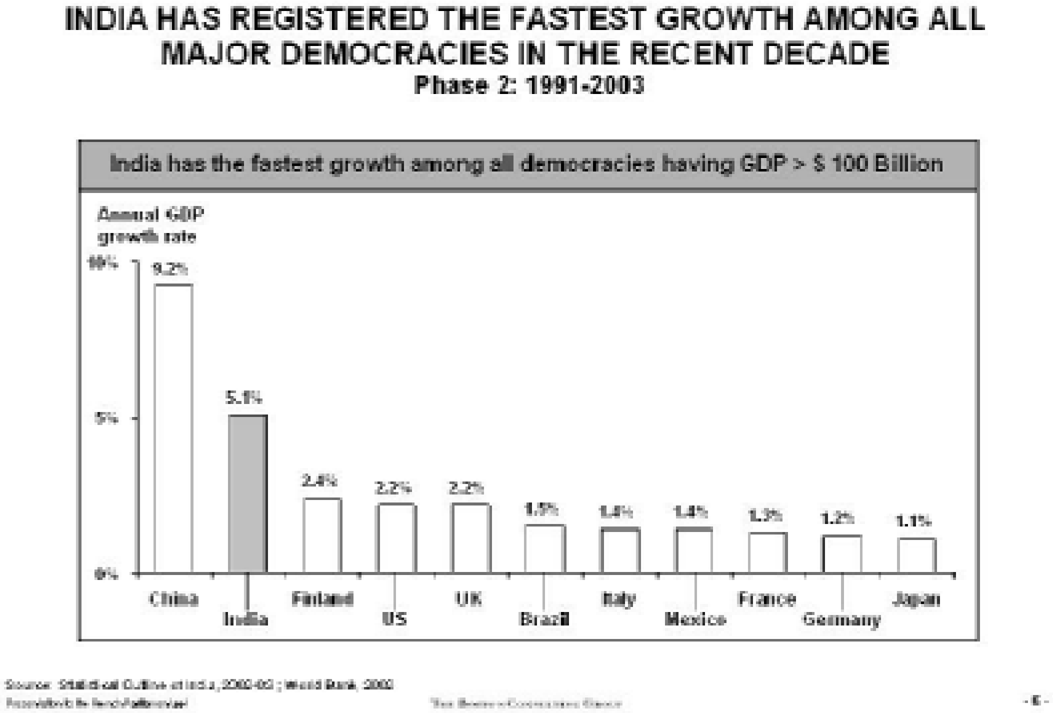
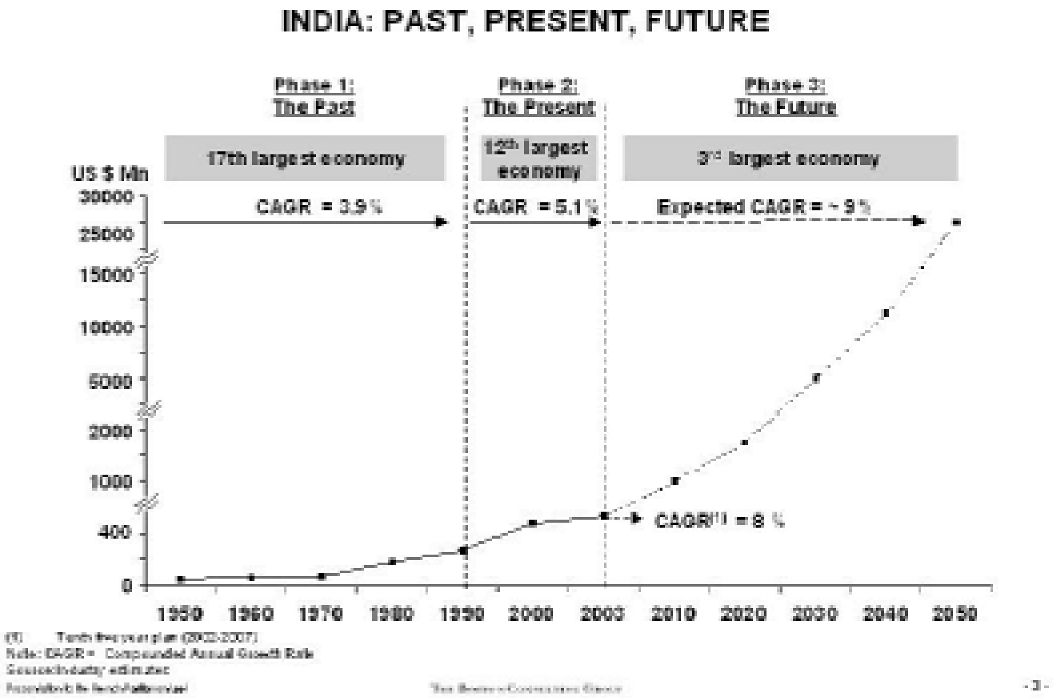
INDIAN ECONOMY

Four Drivers and an Accelerator

It is said that the only way to describe the future is to shape it. As Gordon Gibbons had commented "that the winds and the tides always favour the ablest navigators". So what is India's future? And is the Indian leadership taking advantage of the favourable winds and the supporting tides, "the winds" of increased global integration creating new opportunities, a favourable demographic profile and "the tide" of a BPO surge and the momentum of the new ICE economy. It is now well recognized that in the last 10 years, India has registered the fastest growth among all the major democracies of the world having maintained over 7% growth in 4 years in the 1990s. It represents the fourth largest economy in terms of Purchasing Power Parity (PPP).

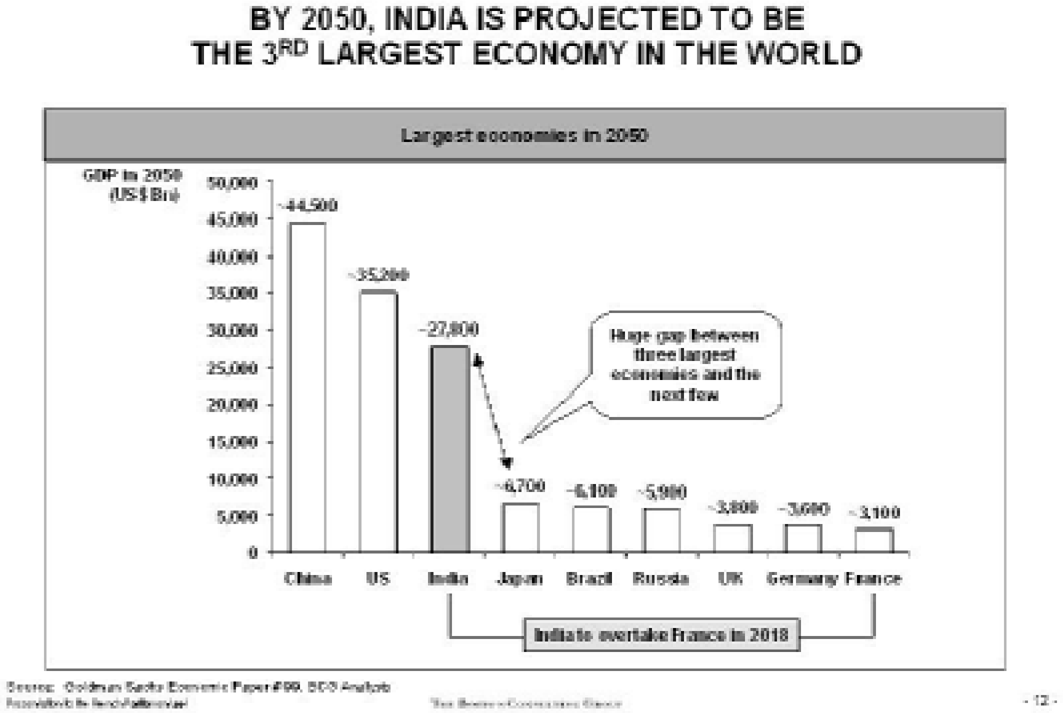


The past, present and future of India represents the story of how the slow growing economy of around 3.9% in the first 40 years of its independence in the second phase in the 1990s became the 12th largest economy.



According to a recent Goldman Sachs report[1], "Over the next 50 years, Brazil, Russia, India and China –the BRIC economies, could become a much larger force in the world economy" and India could emerge as the world's 3rd largest economy over the next four decades.

[1] Global Economics Paper No: 99– Dreaming with BRICs: The Path to 2050

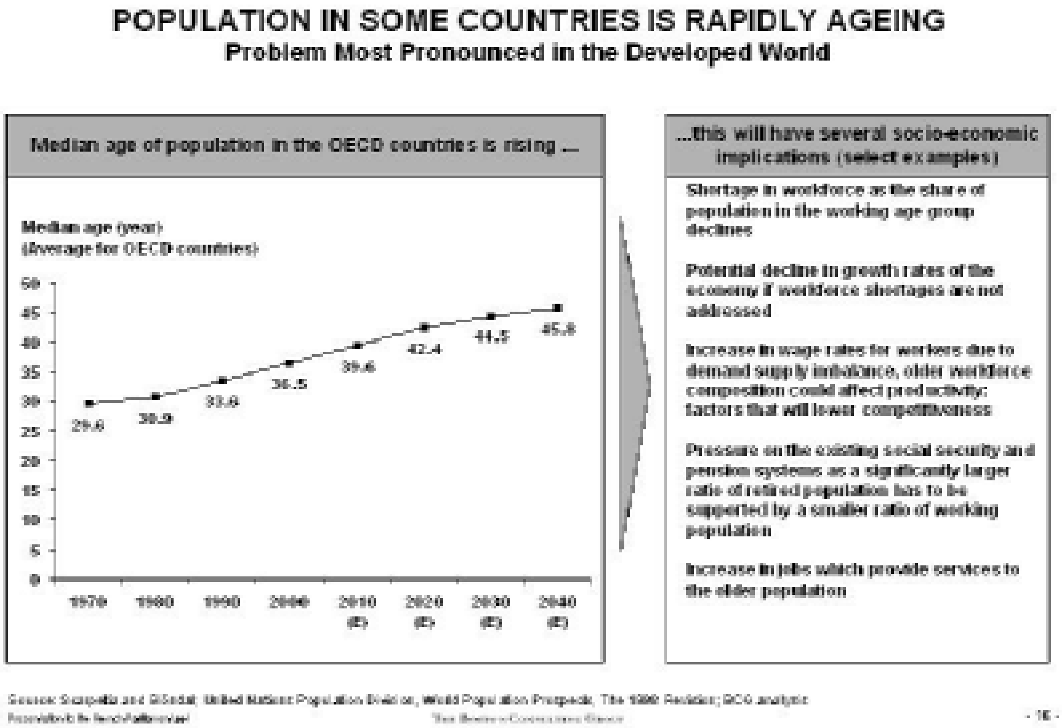


Not that even in the first phase of 50 years there were no gains. Growth was slow due to the adoption of a semi-socialist development model with excessive economic control and inadequacy of physical and social infrastructure. Nonetheless, important gains were achieved by securing food security through Green Revolution, building up capital intensive industries, launching a Dairy revolution, managing the severe foreign exchange shortages and setting up world acclaimed centers of educational excellence like the Indian Institutes of Technology (IIT), which today give us a vantage position in the race of global competitiveness. In the decade of the 1990s, having achieved an average 5.5% growth with per capita income rising at close to 4%, the period also marks the progressive deregulation of the Indian economy cutting across all sectors and segments.

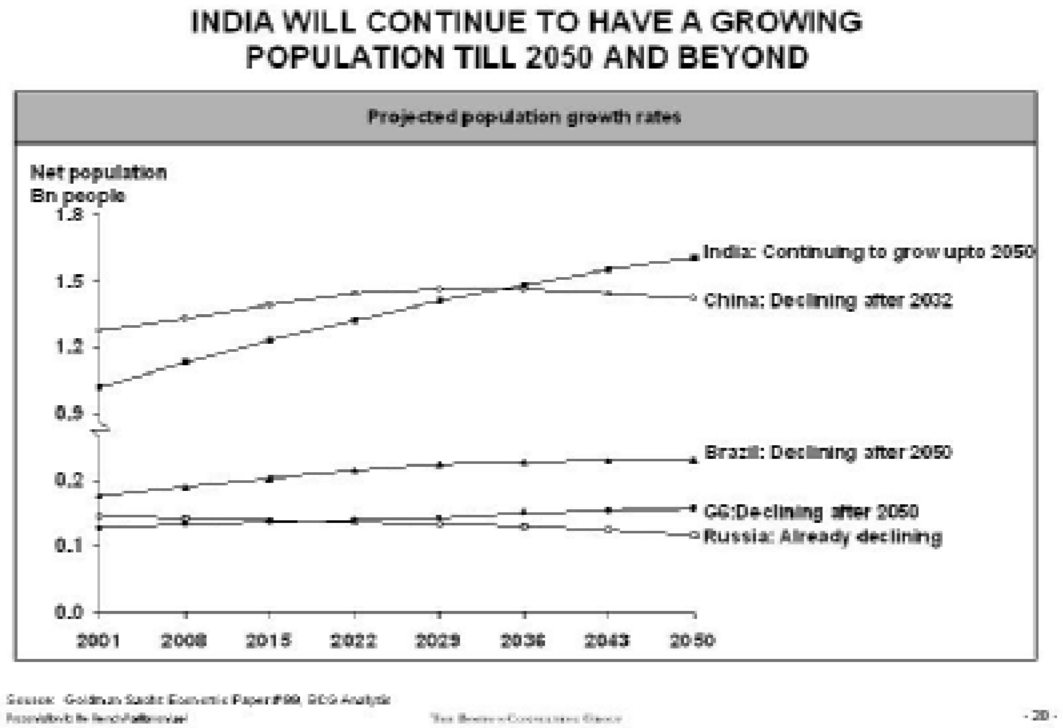
But what is the future? Is the GDP growth rate over 7% expected in the current fiscal year a flash in the pan or is it sustainable? Is the current India fever infectious enough for the heat to last long enough? Will it be a long Indian summer?

The high growth levels achieved during the 1990s which will reach a high point, judged by past standards, in the current fiscal year will be sustained by FOUR critical drivers described below as “DIVIDENDS”.

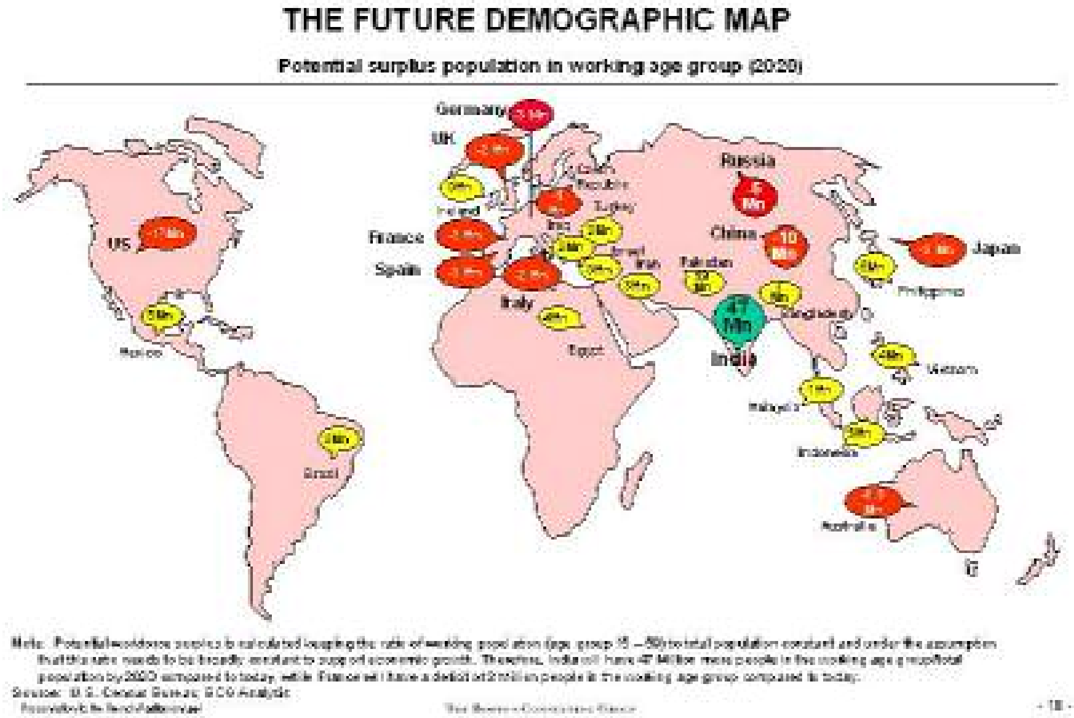
First, the Demographic Dividend. If you look at global demographic trends, it is obvious that the median age of population in the OECD countries is rising rapidly and notwithstanding gains of productivity or a more favourable immigration policy both productivity and growth will be hurt unless there is continued outsourcing of economic activity elsewhere where skilled young manpower is available in abundance.



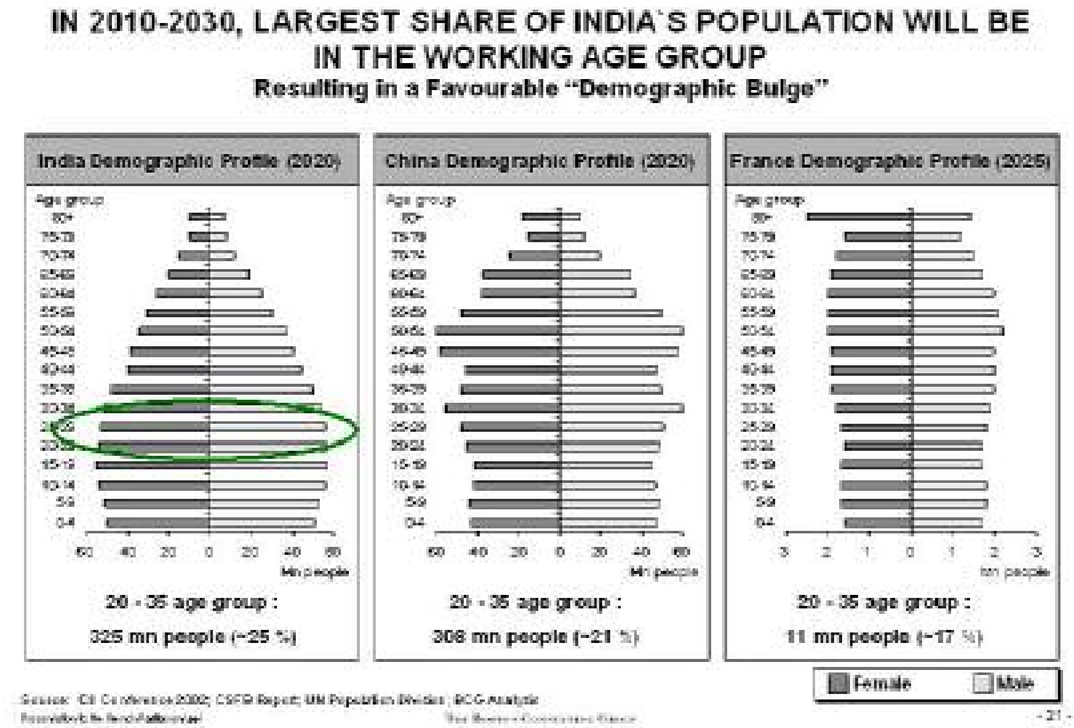
India on the other hand will have the highest number of people in the younger age group – 700 million people out of 1.1 billion people are young; the young population will continue till 2050.



India will have an additional 47 million people in the working age group, while many OECD countries (including France) will face workforce shortages.



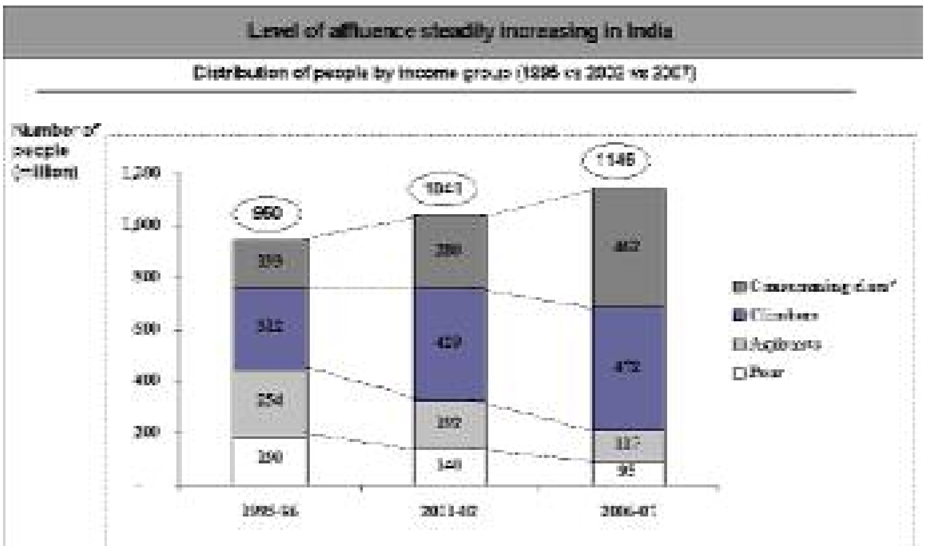
Further, India will have a favourable demographic bulge between 2010 and 2030. The realization of this opportunity will involve inculcation of skills, strengthening the fabric of the educational system and major reforms in the area of human resource development.



Second, the Consumption Dividend

The consequential demographic profile with 325 million people representing nearly 25% of the population by 2020 being in the age group of 20 – 35 gives the benefit not merely of a young working age group but also a larger growing market. Past international experience suggests that this will not only yield a higher savings rate but also result in increased consumer spending. National savings rate in East Asia showed a significant increase to 30% driven by their increase in working age population and India's savings rate is expected to move in the same direction, from the current level of around 23%. In addition, this will also result in a significant increase in overall consumption and even at a 6% compounded annual growth based on PPP, the size of the market would rise from ~ USD 1500 billion today to ~ USD 2700 billion by 2010 and ~ USD 3400 billion by 2015 and of course, at the projected 8% growth, this would be significantly higher. Looking at from another point of view, the level of affluence is steadily increasing in India and even between 1995 and 2002, nearly 100 million people became part of the consuming and rich classes, while over the next 5 years this growth is likely to be dramatic because more than 180 million people will be moving into the consuming and very rich classes.

ECONOMIC GROWTH PROCESS GETTING MORE INCLUSIVE

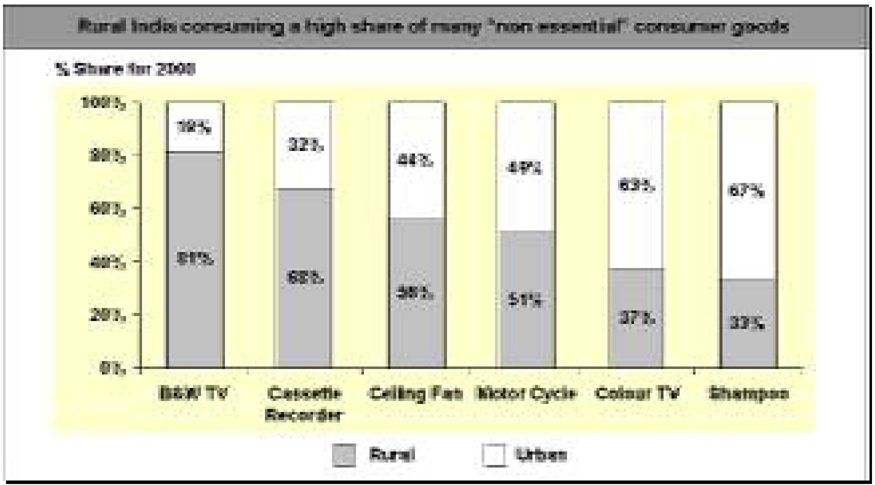


* Includes the rich class

Source: National Council of Applied Economic Research, 2003

On an average, 30-40 million people are joining the middle class every year representing a huge consumption spending in terms of the demand for Cell Phones, Televisions, Scooters, Motor Cars, credit goods and the basket of a consumption pattern associated with rising of income. This growth in consumption would be further boosted by the new phenomenon of easy availability of affordable consumer financing from the Indian banking system. The disbursements in the Indian retail financial services market more than doubled over the last three years. Reckon this in conjunction with the increased propensity of rural population showing increasing preference for articles of mass consumption like Televisions, Electric equipments and generally the white and brown goods. In fact statistics reveal that the share of consumption expenditure of rural India on food items has decreased from 73% to 59% over the last 30 years, while consumption spend on non food items has gone up from 27% to 41% in the same period.

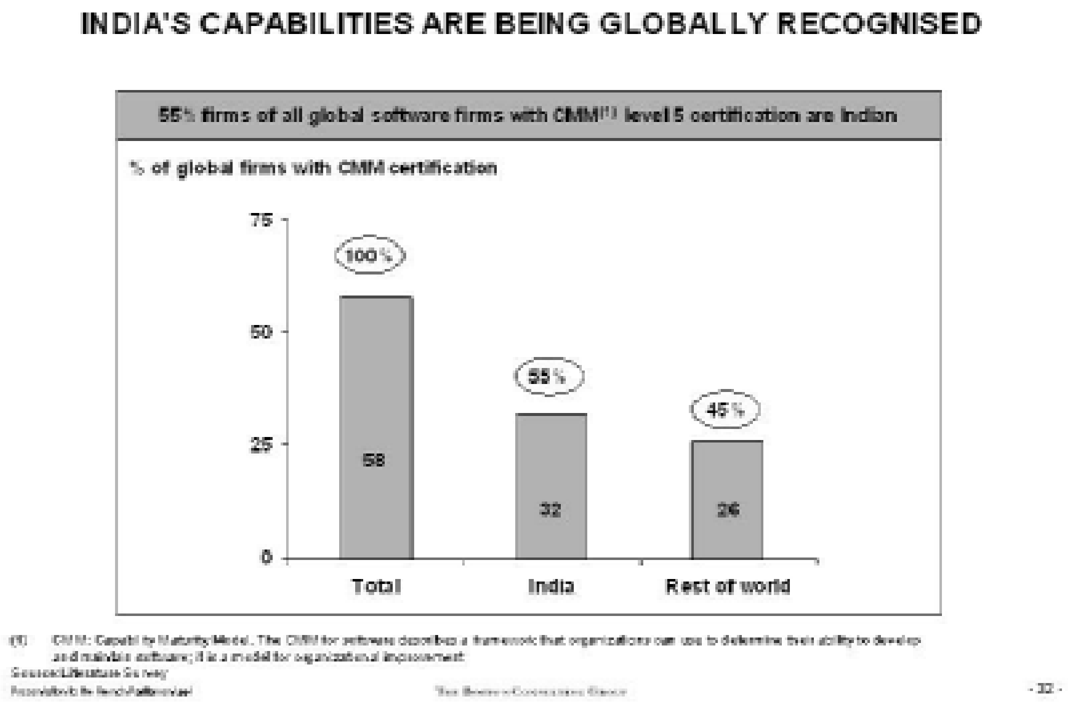
DEMAND ALSO RISING IN RURAL INDIA



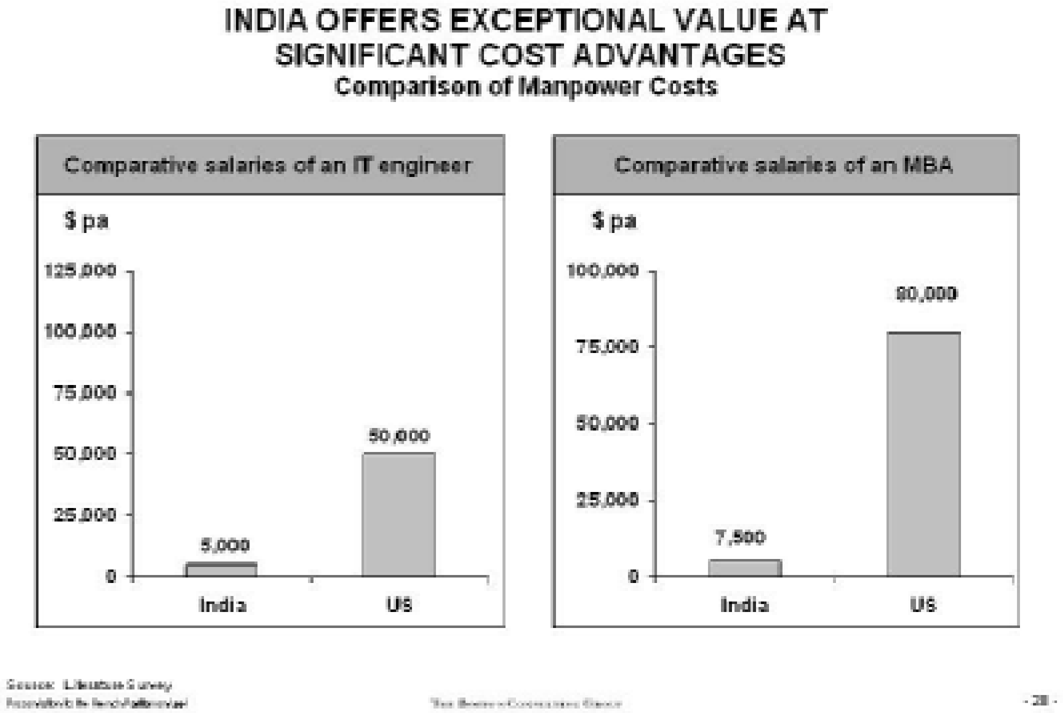
Source: NCAER 1999-00: Literature review

With the increased telephonic connectivity extending to rural India at a rapid rate and the other programme to build dependable round the year rural roads, rural India will be main-streamed with the rest of the economy. The size of the growing market itself even on modest growth assumptions is staggering because we would nearly be adding one France in 3 ½. years and one Australia every year. So the demographic dividend and the consumption dividend will together synergise to become two critical drivers of change and sustained growth.

Third, the Knowledge Dividend. It is no secret that India has rapidly become the service capital of the world based on comparative factor advantage and its ability to move up the value added chain. The Indian pharmaceutical sector has achieved global recognition for production of low cost high quality generic drugs and branded medicines. Of all the software firms which have achieved Level V in the capability maturity model, 55% are Indian firms.

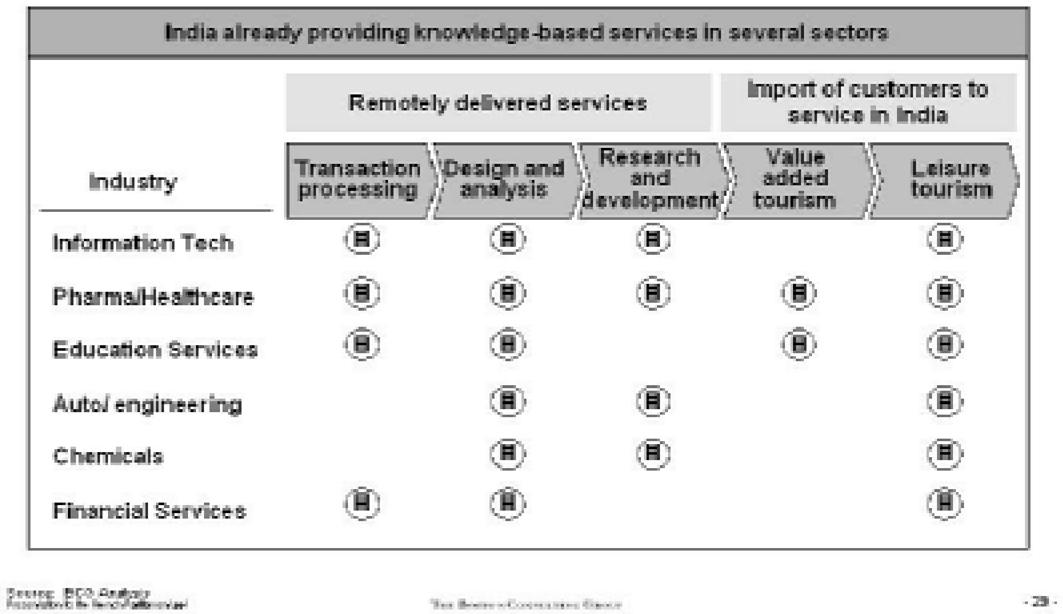


Combine this with the comparative cost advantage where an Information Technology Engineer in the USA would cost 50,000 dollars compared to a modest 5,000 dollars in India and an MBA in the USA costing around 80,000 dollars would be available for only 7,500 dollars in India.



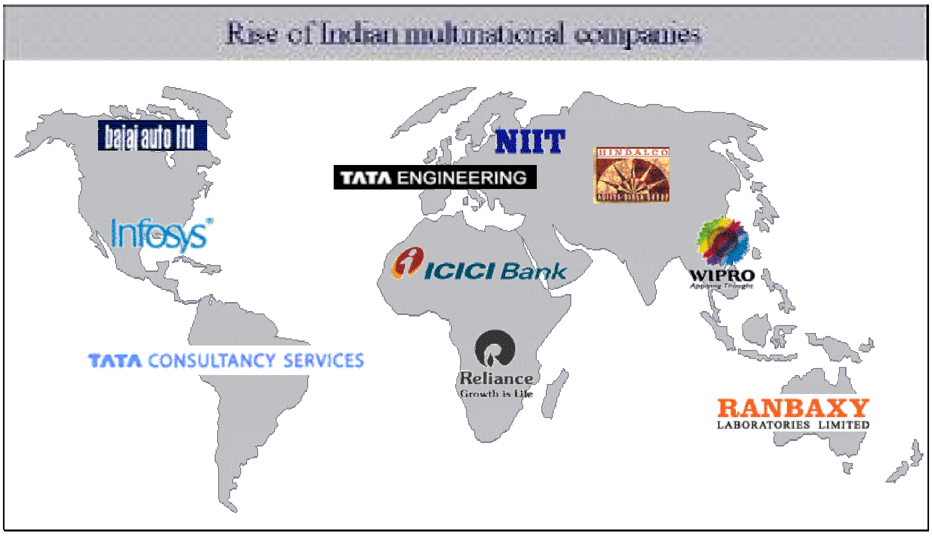
Reckon this with the movement up the value chain. While India has already established itself in areas like transaction processing, it is now rapidly moving up the value chain and achieving comparative advantage in areas like Design & Analysis, Research & Development covering numerous industries, including Information Technology, Pharmaceuticals, Educational services, Auto Engineering, Chemicals and Financial services.

INDIA EMERGING AS THE " SERVICE CAPITAL OF THE WORLD "



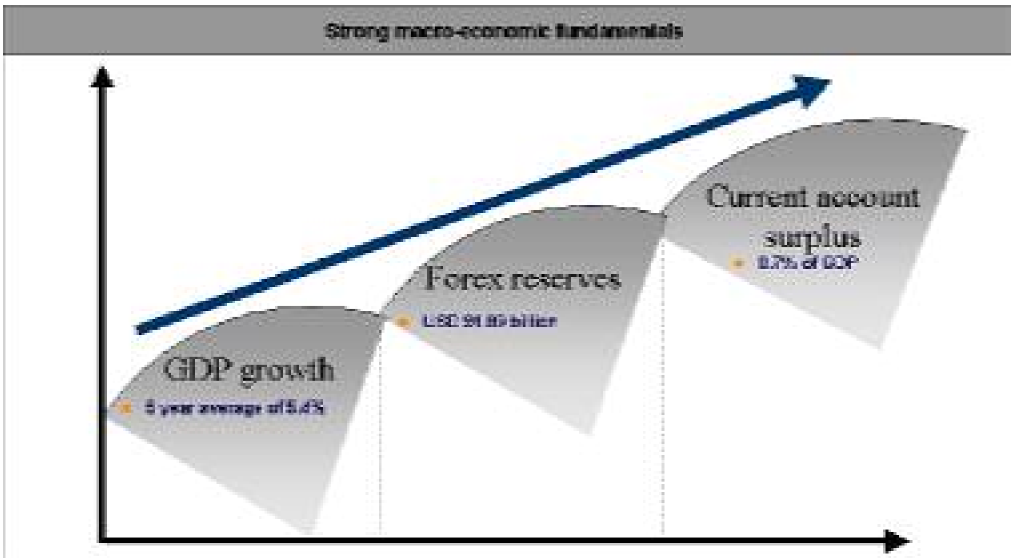
In addition, India is also competitive for services being offered to customers when they come to India either for health treatment, value added tourism or leisure tourism. On a minimum estimate, the impact of India becoming the service center of the world, it would contribute 200 billion dollars to GDP and 40 million in terms of employment (direct and indirect) by 2020.

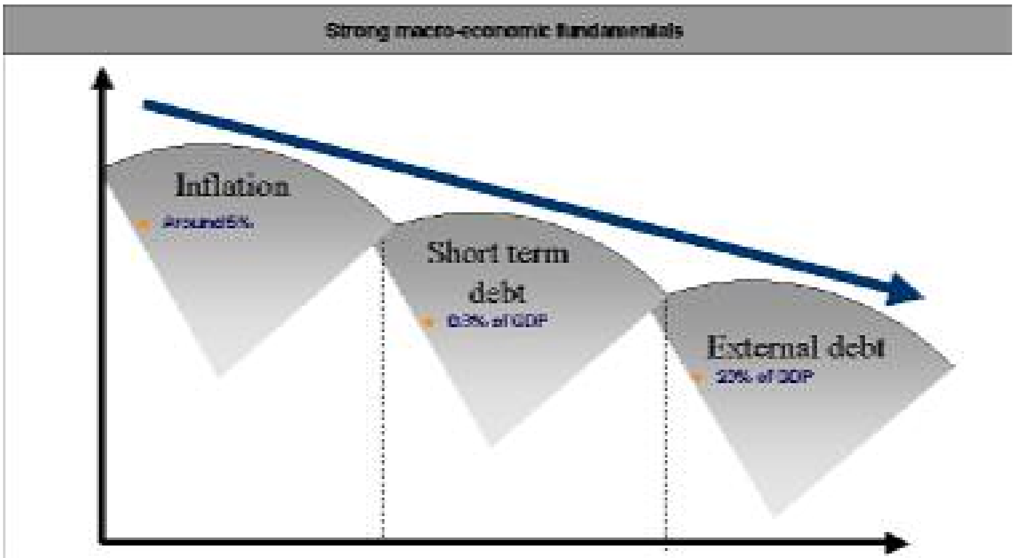
India's knowledge capital has also facilitated a resurgence of the manufacturing sector, exemplified by exports nearly tripling over the last decade and India emerging as the global manufacturing destination of leading multinational corporations, in the areas of auto components, pharmaceuticals, agri products, etc. Leveraging this strength coupled with a global mindset, both service and manufacturing sector companies, have catapulted themselves into the global arena.



Fourth, the Productivity Dividend. Notwithstanding high rates of growth registered in the 1990s and the new growth trajectory which is beginning to unfold, productivity continues to be low in India as compared to other major economies. While productivity has been rising significantly over the past 10 years, there is a huge room to improve rapidly. Furthermore, even modest investment of capital will lead to significant increase in productivity given technological improvements and the favourable Incremental Capital Output Ratio (ICOR). This increase in productivity with modest investment will have a significant and sustainable impact on long term growth rates. This will also raise significantly India's share in global trade which has so far been just below 1% , representing only 20% of our GDP. Both productivity gains and trade gains looking at the current modest levels have a huge room to grow and even with modest changes, this will have multiplier effects on the GDP growth rate.

Finally, what may be called the Reform Accelerator effect. This is crucial for the gains from the dividends to be realized because without the continuation of the reform initiatives, the gains can be frittered away. In this sense, the reforms can be either an accelerator or the brake. Stable macro economic framework of high economic growth with agricultural sector registering 7% growth, industrial sector growing at over 6%, the services sector at 8% with modest inflation, growing foreign exchange reserves, soft interest rate regime underlines the multiplier reform initiatives cutting across all sectors of the economy. The strength of the Indian economy is evidenced by certain key macro-economic indicators.





Source: Reserve Bank of India

❖ Infrastructure is being qualitatively improved. The total deregulation of the Telecom sector with increased competition between private players, a credible regulatory framework and an ambitious programme of both public and private investment is rapidly designed to increase tele-density making telephony and data transmission as well as other related value added services available at costs which are internationally competitive. Telecom subscribers have grown from 9.8 million in FY 1995 to around 65.0 million currently, with nearly 2.0 million new subscribers being added every month. The subscriber base is expected to exceed 180.0 million by FY 2010.

- An ambitious Roads programme of Golden Quadrilateral of 5700 kms connecting the four major metropolitan cities in India substantially completed with a credible North-South East-West spine of 7600 kms cutting across the length and breadth of India is under implementation. A significant modernization and upgradation programme of the existing National Highways of 48000 kms and a major rural roads programme, road connectivity is improving significantly. A model concessionaire agreement seeking private investment through BOT, BOO and various forms of financial engineering to attract private investment in operations and maintenance provides a fillip to growth and employment apart from the multiplier benefits of a more integrated large common market.

- Power sector reforms had two earlier false starts of seeking private investment through payment guarantee mechanism without addressing the endemic issues of a distortionary tariff regime, high transmission and distribution losses due to non-payment and theft leading to insolvency of State Electricity Boards. Since then, credible regulatory institutions are in place in most State Governments. The new Electricity Bill, 2003 effectively deregulates generation, transmission and distribution and a

Accelerated Power Development Reform initiative which catalyses investment in distribution now lays the foundations of securing large investments for enabling energy needs to be met efficiently and affordably.

- The increased privatization of Port activity bringing about a significant improvement in turn around time from 10 days to 5 days. Newer Ports being built on corporate principles and further reforms awaiting the passage of an important legislation to convert Port Trusts into corporate entities will sustain the rising export growth.

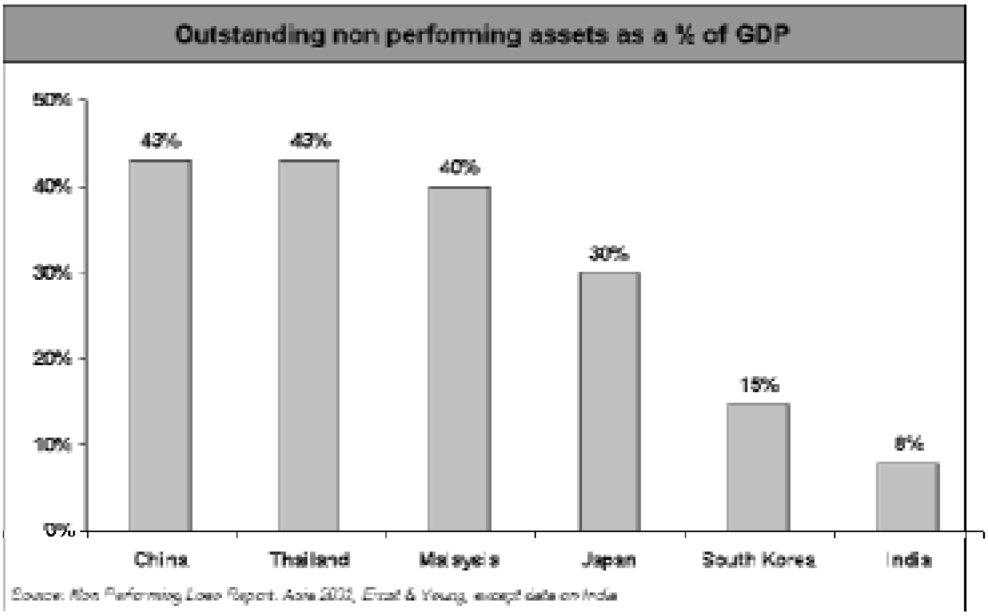
- Civil Aviation reform is on the anvil with the Parliament having enacted the privatization of Airports enabling private investment for upgradation of India's large major airports as well as any other greenfield airport projects. This will improve this key infrastructure for making India an attractive destination for tourists, sourcing exports and making investments. Development of two greenfield private airports, in Bangalore and Hyderabad, has already been awarded to the private sector. The Civil Aviation policy round the corner will substantially deregulate the sector and the Prime Minister's recent announcement of an Open Skies Policy with ASEAN countries has significant multiplier effects through easier and speedier connectivity.

- ❖ A major Railway upgradation programme through reform of India's Railway network, is underway, leading to improving safety standards, introduction of high speed Rail connectivity in the dense corridors, progressive reduction of the distortionary Tariff regime by making freight movement more affordable and greater rationalization of the profile of the new Railway projects. A part of this is being done through a separate company of the Indian Railways, which would form special purpose vehicles, in participation with the private sector, to execute projects.

- ❖ A move towards total deregulation of the external trade sector and elimination of all quantitative restrictions. Leading to a significant reduction in import tariffs with a clear programme to bring this down further to align itself with tariffs in the rest of the regions and a new initiative for Free Trade Agreement with neighbouring countries and ASEAN neighbours fostering closer regional integration.

- ❖ Banking and Financial reforms with the Banks having substantially complied with the BASEL-II norms and significantly reduced the non-performing assets, which according to some estimates are around 8% of GDP and compare favourably with international peer benchmarking .

BENCHMARKING WITH PEERS



The reduction in non-performing asset levels has been facilitated by credible debt recovery tribunals. In addition, further reforms are awaiting the passage of an important legislation in the Parliament, which will reduce Government equity in nationalized Banks to 33%. Some recent measures now enable foreign banks to have equity upto 74% and other easing of restrictions on voting rights. A vibrant capital market where paper-less computer-driven National Stock Exchange undertaking massive transactions is in operation.

- In order to ensure effectiveness and expedite the reform and liberalization processes, independent regulators have also been set up for various industries, including insurance, capital markets, telecommunication, power, ports, etc.

- ❖ An increased emphasis on agricultural reforms by permitting freer movement of all goods and services giving the advantage of large common market, easing of local federal restrictions, the proposed adoption of modern food processing laws and a programme for crop diversification in accordance with changing consumer preference for higher consumption of products, fruits and vegetables will enhance agricultural productivity and secure larger investments.

- ❖ An urban sector reform with progressive adoption of modern transfer of property laws, rent control restrictions and moderation of stamp duty leviable of property transactions will result in progressively freeing up the construction sector.

- ❖ Increased emphasis on promotion of Tourism. The new Civil Aviation and the Road connectivity improvements in conjunction with tourism related infrastructure will enable India to become an important tourist destination.

- The Indian entertainment sector is in the verge of a breakthrough of now being able to secure credible finance at competitive rates through venture capital arrangements which are in the offing.

Having said all these, are there serious risks? Are there constraints which are endemic to the system and would it be difficult to overcome? Clearly, some of the daunting challenges which need to be addressed would include the following :-

- There is clear need to accord high priority to the upgradation of our capability to impart skills and talent to millions of young Indians for giving them gainful employment and main-streaming them in the dynamics of the growth process and benefiting from the new opportunities. This will need improvement in existing vocational training institutes, strengthening centers of technical excellence, investing in creating new institutions and undertaking significant reforms in imparting primary and secondary education.

- The challenge of governance particularly to address issues of a growing regional divide in growth patterns and the need to main-stream the reform agenda from divisive regional politics.

- Persistence of large fiscal deficit will dampen realisastion of growth potential and issues like improving Tax-GDP ratio, rationalization of tax administration, revamping the food procurement system, application of user charges and phasing out non-merit subsidies will pose multiple challenges to the political leadership.
- Sustenance of political support for passage of pending important legislations like Banking, Ports, Mining sector and persuading federal Governments to main-streaming economic policies represent daunting challenges. The competitiveness of the Indian economy would need to be substantially improved through continued soft interest rate regime, reducing cost of financial intermediation, implementing credible labour reforms and managing expectations about the appreciation of the Rupee in the face of rising reserves to prevent erosion of export competitiveness.

However, if past is any guide to the future, political leadership of successive Governments have broadly adhered to the ongoing reform programme. While the programme themselves may have been fine-tuned in the sequencing of the deregulation pattern, there has been no significant reversal of policy with the progressive realization by the political leadership that populist policies are not necessarily popular. We may have moved with caution but never moved backwards. The wider social consensus through which these reforms are being implemented assure their long term continuation and sustainability.

India has reached the critical mass. The mass which is required to perhaps skip a stage in the typology of development moving a large demographic entity into a growth pattern which is increasingly driven by Science & Technology and innovation as sustained drivers of change.

India cannot afford to "limit the realisation of a better tomorrow to be deterred by our doubts of today but must move forward with strong and active faith". India offers new and exciting investment and trade opportunities.

Do bask in the warmth of the long Indian summer that awaits you.