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A Monetary Policymaker's Passage to India

Each year, the President of the San Francisco Fed joins the Federal Reserve Board Governor responsible for liaison with Asia on a "fact-finding" trip to the region. These trips advance the Bank's broad objectives of serving as a repository of expertise on economic, banking, and financial issues relating to the Pacific Basin and of building ties with policymakers and economic officials there. The knowledge gained and the contacts developed are critical in understanding trends affecting the District, in carrying out responsibilities in banking supervision, and in ensuring that policymakers have the understanding of global economic trends necessary to conduct policy and promote the stability of global financial markets. This Economic Letter *summarizes President Yellen's report on her trip to India in November 2005.*

An overview of India's economy

India's economy is booming. Since 1991, economic growth has averaged about 6%, and in the last two or three years it has grown even faster—around 8% —making India, along with China, among the fastest growing countries in the world. Per capita GNP is still very low but has been rising impressively.

The service sector in India accounts for more than 50% of total output—an unusually large share for a developing country—and its growth has been consistently strong. In the industrial sector, growth has been more variable, but it has picked up noticeably in the past two years. The agricultural sector is a major concern to Indian policymakers. It accounts for roughly 20% of India's output and employs 60% of the population. In recent years, farm income growth has slowed due to weak productivity growth. This sector has also been held back by inadequate roads and storage facilities. Clearly, improving performance in agriculture is a key to increasing the welfare of the bulk of India's people, who are not fully sharing in the country's overall growth.

India's business climate is improving, and one concrete sign is that foreign capital is finally flowing in—though not at anything like the scale into China—after a long history of hostility to foreign involvement in the economy.

The single most important reason for stronger growth is economic liberalization. The process dates back to the mid-1980s, following many years of being a highly closed, highly regulated economy based on self-sufficiency and modeled on Soviet-style central planning. In 1991, further reforms were undertaken in the wake of a balance of payments crisis related to massive fiscal deficits. The government began to liberalize inward capital controls, institute banking reforms, and lift trade barriers, further spurring growth. This reform process is continuing.

Our perception is that the broad path of reform is firmly established, though the pace or details may vary with changes in government. In the elections of May 2004, the Bharatiya Janata Party—which was pro-reform—was replaced by a coalition led by the Congress Party. While this coalition has slowed the pace of liberalization, promising to focus on poverty alleviation and rural reforms, it is not backsliding, and several of the government officials we talked with seemed to be aware of the need for more progress in privatizing state enterprises and otherwise encouraging private markets.

The most visible example of the success of India's economy and of unfettered market processes is the IT (information technology) sector. India's advantages as an IT center include its abundance of English-language speakers, strong technical education system, and professional talent with programming and managerial experience. Government policies have also played a key role, as the service sector generally is less heavily regulated, less taxed, and less dependent on physical infrastructure. Many of the IT sector representatives we met expressed confidence that this sector will continue to attract the business of U.S. companies looking for opportunities to outsource some of their activities.

The direct importance of IT services for India's overall growth is easily exaggerated—currently, the sector accounts for approximately 3% of GDP and employs less than 1% of the workforce. But its success has had a very significant positive demonstration effect. In particular, it has created pressure for reform in other sectors, as Indian businesspeople have become more aware of profit opportunities to be exploited both at home and abroad. This is a fundamental change from earlier periods when Indian producers sought government protection from domestic and import competition. The success of this sector has strengthened the conviction that Indian industries can excel at competing in world markets and has generated a palpable increase in confidence about the economy's future.

Restraints on growth

Though liberalization has progressed, many regulations still discourage and distort growth, and much reform remains to be implemented. For example, despite declines in import tariffs, India remains a relatively closed economy. Its ratio of exports plus imports to GDP is between 25% and 30%, well below the levels of other countries in Asia. In addition, although approval for foreign direct investment is easier, such investment is still wholly prohibited in some sectors, such as retailing, agriculture, and railroads.

While liberalization has been critical to India's economic growth, two other factors also have played a role in recent years—stimulative fiscal policy and stimulative monetary policy. Both are a matter of some macroeconomic concern. In the case of fiscal policy, government deficits are huge. Combined central and state fiscal deficits have been around 8–9% of GDP in recent years. The fiscal situation has constrained public infrastructure investment and crowded out private investment. The deficit also undermines reforms in other areas, such as the financial sector, because the government is always concerned about finding buyers for the debt. Complicating matters is the concern about how the new government will finance its social programs, such as a guarantee of limited employment to a member of every household.

In the case of monetary policy, inflation has now risen to around 4%. Demand is being fed in part by rapid growth in consumer spending fueled by consumer credit. Higher oil prices are also a factor. To address the inflation problem, the Reserve Bank of India raised the short-term policy rate in 2005.

Higher oil prices are a concern to India above and beyond their inflationary impact. Since India is a major oil importer, higher oil prices are a hit to real income, and the burden tends to fall disproportionately on India's poor. To shield Indian households, only a fraction of the price hikes for fuel have been passed on to consumers. The difference has been absorbed by oil marketing companies, most state-owned, which has necessitated government subsidies. The subsidies create a further burden for government finances.

In the view of most private and public sector representatives with whom we spoke, the number one barrier to sustainable growth at the recent accelerated pace in India is infrastructure, particularly transportation and power. The government has made some progress in improving airports, seaport facilities, and roadways. In fact, *The New York Times* (2005) did a four-part article on the construction of a major highway around India, dubbed "The Golden Quadrilateral." Nonetheless, problems remain. The power sector faces even more severe problems related to inadequate capacity and substantial distribution losses, estimated to be as high as 40%. The government's ability to undertake needed investments to improve the country's infrastructure is limited by fiscal problems, as I mentioned. As a result, there is increasing focus on greater private sector involvement through public-private partnerships in the development and management of ports and power generation facilities.

Another factor restraining growth in India is a system of labor market regulations that restricts flexibility in firing as well as restrictive business regulations more generally. In the view of the experts from the multilateral institutions and the Indian business leaders with whom we met, these regulations are a barrier to significant expansion of India's manufacturing sector, which is necessary to create more jobs in the economy for less-skilled workers. According to World Bank measures (2006), India's degree of labor market flexibility and general business climate rank very low in comparison to many other developing countries, including China. India's textile industry, which employs 30 million people, has been one of the more highly regulated sectors and is still dominated by many small businesses. As a result, this industry, unlike China's, was not well positioned to gear up in response to the end of the multi-fiber quotas on exports to industrial countries. Although Indian companies have found ways around the labor laws by outsourcing production to the unorganized sector, greater labor flexibility is important to the ability of the economy to achieve scale economies and generate more jobs.

India's banking sector

As noted, the health of the banking sector and the state of bank supervision and regulation were a focus of our trip, which is natural, given our Bank's responsibilities in assessing the quality of home country supervision of foreign banks operating in the United States. Prior to 1991, the banking system in India was characterized by weak asset quality, low profitability, and limited transparency due to directed lending and regulatory forbearance. However, things have improved considerably. Nonperforming loan levels have been falling in India and are now in the 4-5% range, and bank capital is adequate.

Two concerns relating to the health of the banking sector have, however, attracted concern. First, there is concern that aggressive retail loan growth may lead to future asset quality problems. I noted earlier that India is experiencing a credit boom, and it is possible that lending standards may be declining, which could lead to higher nonperforming loans in the future.

A second concern relates to the banking system's high level of exposure to long-term government bonds. Although government bonds have fallen to less than 30% of the banking system's assets—from nearly 40%—this level remains high and entails risks as interest rates continue to rise.

An important feature of India's banking system is that, as in China, state ownership of banks is high. Overall, state-owned entities account for close to three-fourths of total financial system assets.

Indian private banks are flourishing. They have adopted relatively stronger risk-management processes, using technology effectively and developing new financial products. The most successful of these banks are ICICI and HDFC, which continue to increase market share and compete successfully with both state-owned and foreign banks.

Foreign banks would like to expand in India, but ownership remains restricted. To date, there are roughly 30 foreign banks operating in India, but they represent only 7% of total assets. The Reserve Bank of India understands the benefits that an increased foreign banking presence can bring to the financial sector, but it is committed to giving Indian banks a cushion of time to prepare for increased competition. Reforms to foreign ownership policy were announced earlier this year but they do not materially change the way foreign banks can operate until 2009.

Conclusion

On a fact-finding trip to India, it would be impossible, and, indeed, a huge waste, to ignore what glimpses of Indian life and culture one might get. Though we visited only three cities, we were struck by the dizzying beauty and the dizzying disparities that India has long been known for. We were lucky enough to see the serene magnificence of the Taj Mahal. Another manmade wonder—more of the 21st century than of the 17th—was a technology campus, for all the world like any such facility you might see in Silicon Valley. But en route to both, we saw other faces of India—shanties, roads clogged not just with cars, but with pedestrians, peddlers, pushcarts, cows, goats, even a caravan of camels. Scenes like these are not only unforgettable, they are also emblematic of the challenges the country faces. Our visit raises my hopes that India will remain on the path of liberalization, with the ultimate goal of improving the economic well-being of its people.

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Reference

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