RESERVE BANK OF INDIA
BULLETIN

JANUARY 2013

VOLUME LXVII NUMBER 1

The Reserve Bank of India Bulletin is issued monthly by the Department of Economic and Policy Research, Reserve Bank of India, under the direction of the Editorial Committee.
The Central Board of the Bank is not responsible for interpretation and opinions expressed. In the case of signed articles, the responsibility is that of the author.

For subscription to Bulletin, please refer to Section 'Recent Publications'

The Reserve Bank of India Bulletin can be accessed at **http://www.bulletin.rbi.org.in**

CONTENTS

MID-QUARTER MONETARY POLICY REVIEW: DECEMBER 2012

Mid-Quarter Monetary Policy Review: December 2012

Monetary and Liquidity Measures

On the basis of the current macroeconomic assessment, it has been decided to:

- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.25 per cent of their net demand and time liabilities; and
- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 8.0 per cent.

Consequently, the reverse repo rate under the LAF will remain unchanged at 7.0 per cent, and the marginal standing facility (MSF) and the Bank Rate at 9.0 per cent.

Introduction

2. Since the Second Quarter Review (SQR) of October 2012, the global economy has shown some signs of stabilisation although the situation remains fragile. While activity is picking up in the US and the UK, near-term prospects in the euro area are still weak. Moreover, there is no clarity as yet on how the US 'fiscal cliff' might be managed. While several emerging and developing economies (EDEs) are gradually returning to higher growth, weak external demand and contagion risks from advanced economies (AEs) render them vulnerable to further shocks.

3. On the domestic front, there are some incipient signs of pick-up though growth remains significantly below its recent trend. Also, though consumer price inflation remains stubborn, the pace of moderation in wholesale price inflation has been faster than anticipated. With food and manufacturing prices expected to edge down further, inflationary pressures may ease somewhat in the coming months.

Global Economy

4. Since the SQR, global activity has remained sluggish, but country growth trajectories appear to be de-coupling. In the US, the revised GDP estimates for Q3 of 2012 indicate that a pick-up in growth is underway, supported by rising non-farm payroll employment, home sales and house prices. In order to support a stronger recovery, the Fed continued its quantitative easing, and announced further expansion through purchase of longer-term treasury securities. In contrast, euro area growth contracted for a second successive quarter in Q3, and retail sales have been declining at a faster pace in Q4. In Japan, GDP growth contracted in Q3, triggering a fresh dose of fiscal stimulus. Overall, the global purchasing managers' index (PMI) for November points to acceleration, with the all-industry index recording an eight-month high. International energy and non-energy commodity prices softened in November for the second month in a row, suggesting lower inflationary pressures.

Domestic Economy

Growth

5. GDP growth in Q2 of 2012-13 at 5.3 per cent was marginally lower than 5.5 per cent in Q1. However, there are some indications of a modest firming up of activity in Q3. Industrial activity rose sharply in October but this is, in large part, due to a low base and festival-related demand which propelled the growth of both consumer durables and non-durables into double digits. Significantly, capital goods production recorded a growth of 7.5 per cent after 13 successive months of decline. The manufacturing PMI rose moderately in November as order book volumes expanded. While the services PMI declined from a month ago, expansion in new business and order book volumes suggests positive sentiment about increasing activity in the months ahead. In the farm sector, *rabi* sowing coverage is expanding steadily, improving the prospects of agricultural growth.

Inflation

6. Headline WPI inflation edged down to 7.2 per cent in November, mainly owing to softening of prices of vegetables, minerals and fuel. On the other hand, prices of cereals and protein-based items such as eggs, fish and meat firmed up further. Significantly, core (non-food manufactured products) inflation eased, aided by decline in prices of metals, cement and chemicals. The seasonally adjusted three-month

moving average annualised momentum indicator also points to ebbing of inflationary pressures. However, in striking contrast to wholesale inflation developments, retail inflation remained elevated. The new combined (rural and urban) CPI (Base:2010=100) inflation increased in November, reflecting sustained food inflation pressures, particularly in respect of vegetables, cereals, pulses, oils and fats. The non-food component of the index also suggested persistent inflationary pressures.

Monetary and Liquidity Conditions

7. While money supply (M_3) growth remained below its indicative trajectory because of lower deposit growth, non-food credit growth rose above the indicative trajectory of 16 per cent suggesting some pick-up in economic activity. Liquidity conditions have remained tight in Q3 due to large government balances with the Reserve Bank and the widening wedge between deposit and credit growth. With a view to containing the liquidity deficit at reasonable levels, the Reserve Bank conducted open market operations (OMOs) on December 4 and 11, injecting primary liquidity of ₹232 billion. Accordingly, money market rates remained close to the repo rate.

External Sector

8. With the step-up in oil imports persisting despite the moderation in crude prices, the cumulative trade deficit for April-November widened from its level a year ago indicating significant risks to the balance of payments from the adverse external environment. Even as capital inflows improved compared to Q2, there were downward pressures on the rupee reflecting the large trade and current account deficits.

Outlook

9. Lead indicators point to a modest firming up in the momentum of global growth over the rest of 2012 and in 2013 if there is firm policy action in the euro area and the US. The biggest risk to the outlook stems from political economy considerations that could impede, delay or erode resolute policy action. The consequences could be deepened financial stress and heightened risk aversion. For EDEs, the threat of spillovers remains significant in view of the depressed outlook for global trade and volatile capital flows. Although inflation pressures appear to be moderating, elevated food and commodity prices remain contingent risks, especially for EDEs facing domestic supply constraints.

10. On the domestic front, GDP growth is evolving along the baseline projection of 5.8 per cent for 2012-13 set out in the SQR. The recent policy initiatives by the Government and further reforms should help to boost business sentiment and improve the investment climate. As regards inflation, excess capacity in some sectors is working towards moderating core inflation. Furthermore, the easing of international commodity prices, particularly of crude, is expected to impart some softening bias to the evolving inflation conditions if it is not offset by the impact of rupee depreciation. The Reserve Bank is closely monitoring the evolving growth-inflation dynamic and will update the formal numerical assessment of its growth and inflation projections for 2012-13 as part of the third quarter review in January 2013.

Guidance

11. Headline inflation has been below the Reserve Bank's projected levels over the past two months. The decline in core inflation has also been comforting. These emerging patterns reinforce the likelihood of steady moderation in inflation going into 2013-14, though inflation may edge higher over the next two months. In view of inflation pressures ebbing, monetary policy has to increasingly shift focus and respond to the threats to growth from this point onwards. Liquidity conditions will be managed with a view to supporting growth as stated in the SQR, thereby preparing the ground for further shifting the policy stance to support growth. Overall, recent inflation patterns and projections provide a basis for reinforcing our October guidance about policy easing in the fourth quarter. However, risks to inflation remain and accordingly, even as the policy emphasis shifts towards growth, the policy stance will remain sensitive to these risks.

December 18, 2012

SPEECHES

*Transit Path for Indian Economy: Six Steps for Transforming The Elephant into A Tiger**

K. C. Chakrabarty

Shri Prabhat Jain and other members of the Delhi Chapter of the Young Presidents Organisation! It is my pleasure to be here amidst some of the young captains of the Indian industry, who, I believe, would continue to guide their respective enterprises for a foreseeable future and make immense contributions in shaping the Indian Economy going forward. I have been asked to speak to you today on 'transforming the elephant into a tiger' and in this regard, I would suggest six steps that I think are essential for such a transformation. However, at the outset, I thank the Delhi Chapter of the Young Presidents Organisation (YPO) for inviting me to share my thoughts on this important topic. YPO has really established itself as an extra-ordinary network of young global business leaders and a think tank on issues that are critical to economy, businesses and society. I am told the network has hosted some illustrious speakers in the past and therefore, I have to live up to high expectations. I believe the decades of my experience in commercial banks and in the Central Bank have provided me with insights into enterprise, governance, growth and society and their impact on nation-building, which, I would share with you today and hope you find them interesting and worth emulating.

Let us now focus on the topic for the evening. Transforming the elephant into a tiger can mean different things to different people. In reality, the state of the art in genetic engineering still cannot contemplate such a modification. An Ang Lee or a Steven Spielberg can, of course, use computer generated special effects to bring about such a transformation. But it is time to get real – given that the metaphor of elephant is used to denote the Indian economy and deals with our lives and the future of our children.

In 2007, Dr. Shashi Tharoor wrote an enchanting book, 'The Elephant, The Tiger and The Cellphone: Reflections on India: – The Emerging 21st Century Power'. The book, ingrained in history, culture and socio-economic change, criss-crosses the Indian life from Ajanta-Ellora and cricket to cellphones and call centres and makes a simple point of Indian growth effecting change in daily lives and imparting confidence to the Indian people. In December 2008, the Economist of London published a special report that India was elephant, not a tiger. It noted that for all its chaos, bureaucracy and occasional violence, India has had a remarkably successful past few years. But, it wondered how it will cope with an economic downturn and the general elections that were about to follow. It added that the democracy tax was rising and storm-clouds were gathering. The prognosis, however, were proven to be off beam by the events that followed. The elections removed uncertainty and the Indian economy staged a V-shaped recovery clocking 8.4 per cent growth during 2009-10 and 2010-11. Yet, we lost steam and the chinks in the tiger skin that we tried wearing, got exposed.

In July 2011, Shri Swaminathan Anklesaria Aiyar, my journalist friend and a profound observer on the political economy of India, wrote a paper for the Cato Institute, 'The Elephant that Became a Tiger'. In this paper he persuasively argued that 20 years of economic reforms in India had transformed the Indian economy into a tiger. Later the same year, the Reserve Bank Governor Dr. Subbarao, while delivering the Haksar Memorial Lecture, argued that India may be an elephant, but even elephant can dance. The elephant dance was disrupted by the zoo party in the form of global financial crisis. He then suggested ten steps to get back on course by re-jigging the elephant dance.

* Address delivered by Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India at the interaction with members of Delhi Chapter of the Young Presidents Organisation at New Delhi on December 7, 2012. Assistance provided by Dr. Mridul Saggar in preparation of this address is gratefully acknowledged.

Growth in India has clearly slowed down since then to 6.5 per cent in 2011-12 and a likely 5.8 per cent in 2012-13, with significant downside risks. The twin deficits – fiscal and balance of payments – have compounded our problems. This may set us thinking on whether we are an elephant or a tiger or a goat, about to be devoured by global forces and our domestic inaction? So should we at all pursue the tiger dream? If yes, what do we need to do to earn the tiger tag?

The elephant and the tiger: Which one should we prefer?

Before I touch upon what we need to do, the first step is to understand what these metaphors mean. So let me upfront visit the key attributes of elephants & tigers. There are four key attributes of an elephant – the size, the herbivores nature, its perceived moderate pace and its anatomy that includes large ears, the trunk and the tusks. Tiger, on the other hand, is not as large as the elephant, but is largest of the cat species. It is carnivore, and is known for its speed and agility. Its anatomy includes the stripes, the powerful jaws and razor sharp teeth, sharp claws and a flexible backbone. But, what conclusively differentiates the two is the tiger's killer instinct.

I think, in terms of size, the Indian economy is, of course, an elephant. It is also herbivores by habit given its democratic structure, unlike the carnivore habits of tigers and dragons. In terms of speed, many people have a misconception that elephants can't run or walk fast. The fact is that elephants can walk as fast as 25 miles per hour (mph), while tigers can run only a shade faster. Bengal tigers can run at 35 mph, but for short spurts and they can't keep this pace for long.

So, in my view, it is not axiomatic that one should try transforming the elephant into a tiger. Yes, we could do with an added bit of speed but what we should really aim at is developing a tiger's killer instinct. These, together with a better use of our anatomy or resources, both human and capital, would help us achieve what the dragons and the tigers have achieved, perhaps, with a smaller downside. For this to happen, in my view, we need to take the following six steps:

1. Preserve Demographic Dividends by investing in human capital

India's demographic dividend presents the country with a great opportunity to enhance its growth and seek convergence of per capita incomes with that in the developed world. India's birth rate has fallen from 45.6 per 1000 in 1951 to an estimated 21 currently, but still remains highly driven by a slowly falling infant mortality rate that remains high at about 46 per 1000. The death rate has fallen dramatically from 37.2 per 1000 birth in 1951 to an estimated 7 currently, but has still not caused population ageing. Median age for India's population is about 27 years compared with over 40 for most OECD economies. It will add significantly to its labour pool and, even as the median age bucket rises, it will still be at a relatively young 30-34 age bracket by 2026. India's age-dependency ratio (ratio of dependents-people younger than 15 or older than 64-to the working-age population) is currently about 54. This is already lower than Japan and France.

Most developed countries would see a rapid ageing of their population over the next 2-3 decades putting severe pressure on their social security systems with the rise in dependency ratio. The overall median age of these countries rose from 29.0 in 1950 to 37.3 in 2000, and is forecast to rise to 45.5 by 2050.

Many developing countries like China, Brazil and Thailand too face issues of ageing population having passed through the demographic transition. Over the last 60 years, China has experienced demographic change at a historic pace that had a profound impact on its population structure. Baby boom began in the mid-1960s after the period of 'Great Leap Forward' saw famines and a sharp rise in death rate and a fall in birth rate. China is now a 'post-transitional' society, where life expectancy has reached new heights, fertility has declined to below-replacement level, and

rapid population ageing is expected over the next few decades. China's population will start to shrink after reaching a peak of about 1.4 billion by 2025 A.D. The median age of its population could touch 50 years by then. India's population would overtake that of China at that point. Its population is expected to peak only at 1.7 billion by 2060 A.D.

Clearly, India has a potential advantage of demographic dividend over its emerging market peers. But, this demographic dividend could be a boon or a curse depending upon how we exploit it, for, the time to reap these gains is finite. By the turn of this century, India would be facing a demographic discount rather than dividend because India's population would have aged and the developed countries' population would be much younger. So what do we need to do to reap the demographic dividend while they exist?

The very first thing is to invest in the resources that are expected to give us advantage. India invests much less than it should in its human capital. The combined spend of central and state governments in education, is just about 3.3 per cent of GDP, while that on health is another 1.3 per cent of GDP. In contrast, the European Union (EU) countries spend from their general government account, 5.5 per cent of their GDP on education and 7.5 per cent of their GDP on health – *i.e.,* nearly three times more of their GDP. Canada's public spending on health alone is over 11 per cent of their GDP and that on education is nearly 5 per cent. India needs to step up its public spending on education and health considerably over the next five years. However, spending alone does not guarantee high quality human capital. We also need to focus on the quality of this spending and think whether we can achieve better outcomes with less spending.

The second step we need to take is for right skilling of our work force. There is shortage of trained manpower for the industry, both at the bottom of the pyramid and higher up the ladder. India is often considered to be a source for skilled labour supply to the rest of the world, given its sheer size of manpower. It is often not recognised that over four-fifths of our rural population and over half of our urban population remains unskilled. Women participation rate in the labour market remains poor. The biggest problem is the lack of focus on technical education that could absorb a large chunk of unskilled labour, if backed by greater push to primary education. Less than 11 per cent of the job-seeking population in the age group of 15-29 receives any form of vocational training in India and only one of every three who do get vocational training receive it from specialised training institutes. Furthermore, even in the value added segment, where we have the largest pool of skilled manpower, *i.e.,* in the area of information technology, real wages are rising at a pace that may impact our competitiveness.

The biggest challenge is to ensure jobs for additional supply of labour that comes in to join the workforce. On a rough basis, about 10 million people would need a job every year for the next 15 years. Though disguised unemployment in agriculture sector has reduced over the years, it may not be possible for the sector to provide additional jobs given the rising rural wages and the need to shift to a corporate, more mechanised and capital intensive model of farming. While the services sector has led India's growth and employment story for some time now, India's growth pace may not be sustained unless the manufacturing sector also becomes more competitive and creates lot more jobs. This poses a significant challenge in employment generation and skilling our work force.

2. Improve productivity and efficiency

Productivity is an important driver of growth. Productivity depends on the efficiency with which scarce resources are allocated – be it your time, work effort, natural resources, capital or any other inputs. A great deal of the growth for most countries can be explained by productivity growth, especially total factor productivity growth (TFPG). Factor accumulation (such as increase in labour or capital) explains a smaller part of the growth. Given this experience, if

India were to become a tiger, it would need to focus on technological developments to improve its rate of TFPG. Capital deepening may also help, but the key lies in overall productivity enhancements.

In India, output per worker has increased at an impressive rate in the services sector after the reforms initiated in early 90s. In this period, TFPG growth has also been impressive for this sector, though I will eschew quoting precise numbers as the growth accounting research generally gives varied quantitative estimates. TFPG growth has also improved for the manufacturing sector since the 1980s. So, progress is being made. However, the rate of this technical change, still, has been lower than that for the East Asian economies during the period in which they earned the tag of being East Asian tigers.

I would rather focus on the issue of larger policy initiative that would be necessary in the quest to transform India into a tiger. In this context, I would make four suggestions. First, improving agriculture productivity is necessary as, clearly, increase in area under cultivation is just not practical and, therefore, increasing demand for cereals, pulses, fruits and vegetables would need to be met by improving yields. Substantial productivity enhancements are possible on the farm through adoption of precision farming techniques, better cultivars and optimal water management. Better adoption of modern technologies in the area of biotechnology, genomic tools, cost-effective and eco-friendly integrated pest management technologies, seed-supply chains and systems, regionally adapted varieties and hybrids, would help.

Second, we need to focus on issues confronting our Small and Medium Enterprise (SME). SME sector accounts for over a third of our industrial output and contributes an equal share of our total merchandise exports. In the current downturn, SMEs are facing adverse business climate with rising receivables, inadequate credit and high cost of credit. SME sector does not enjoy the economies of scale and scope that a large corporation enjoys. It also cannot fully reap the benefit of information technology as it has high sunk cost and a high rate of obsolescence. Though having strong links with large firms, institutional mechanisms for transfer of technology to SMEs are lacking. If SMEs are to effectively integrate with supply chains, we need to ensure that links of finance and technology with large firms work at all times.

Third, as I mentioned a little earlier, India's next growth push has to come from manufacturing sector. We had a missed century of opportunities. India cannot boast of one big 'home grown' global brand while much smaller nations like South Korea, Taiwan, *etc.* have plenty of them. Our abundant human capital has not been effectively channelised for supporting the manufacturing growth. But what I would really blame for this is a lack of 'R & D' culture that we suffer from. Globally, India figures at near the bottom in terms of R&D intensity. It spends less than one percentage of its GDP on R&D expenditure, Countries like Israel, Finland, Sweden, Korea, Japan, US and Germany have R&D intensities that are higher by three times or more.

Fourth, a key issue related to productivity is our attitude to work. It is strange that India, that epitomised the dignity of labour in the Early Vedic period, has imbibed a culture that does not respect workers. We have forgotten Swami Vivekananda's contribution in equating work to worship. No form of work, whether manual or intellectual is less inferior to the other. As a nation, we have been steadily neglecting our respect for dignity of labour. Since the manual labour does not receive the same respect as an intellectual work in India, work efforts are lost. This results in lower GDP and lower Welfare. Individuals idle away than take up a manual job. What else would explain the fact that labourers from poor states like Bihar, Orissa, UP, *etc.* migrate and work hard in the agricultural farms in Punjab and Haryana, while refusing to do the same in their own locality where the land is more fertile and same amount of labour

would be much more productive. We must emulate the western society in this regard where no form of labour is discriminated against. If President Cleveland could accept dignity of labour in 1894, more than a century down the line it is time that we give respect to casual labour that operates around us – be it our maids, our drivers or the workmen in our factories – a due recognition and respect. If we do so, more women and men would join the workforce. Unemployment would be reduced and Indian industry would become more competitive globally.

3. Revive infrastructure investments and harness natural resources better

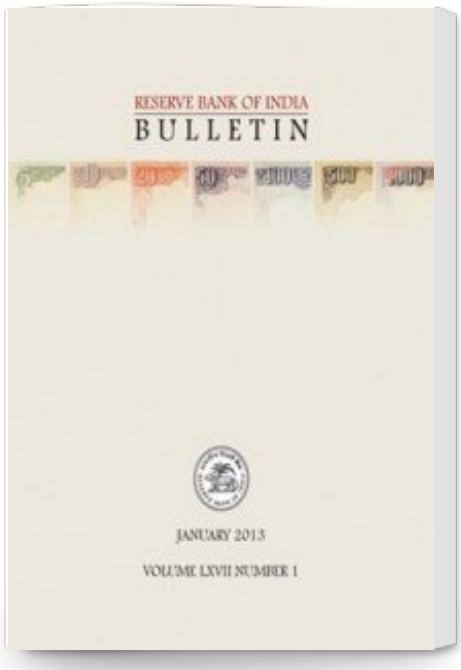
Much has been said about India's infrastructure deficit and rightly so. India does not have sufficient roads, nor sufficient power. When I was growing up, I was taught that India is a land of poor, but is rich in resources. Today we have made a giant leap in lowering poverty and still remain abundant in natural resources. Yet, we have not learnt to optimally utilise them. Take for example coal, which accounts for India's 55 per cent of energy needs. We have hard coal reserves of around 246 billion tonnes, of which 92 billion tonnes are proven. Yet, we are able to produce only 530 million tonnes of coal, leaving supply shortages of over 150 million tonnes. Coal shortages are constraining our power generation and though about 55 GW of new capacity was created during the 11th Five Year Plan (FYP), a large part of it remains unutilised due to coal shortages. Private sector has failed to develop most of the new coal blocks that were allotted to them. We ended up with inadequate planning and poor execution in this area. We are now planning to create even more thermal power capacity during the 12th FYP, but remain unsure of coal supplies. At the same time, banks have heavily extended themselves into lending to power sector both on generation and distribution side. On the distribution side, the State distribution companies (discoms) are sitting on huge losses and bank debt that is threatening to go bad. The end result is a loss of business confidence that has brought the investment boom to a premature halt.

What is most important in this context is to revive the confidence for investing and lending to the infrastructure sector. The government, in recent period, has taken several steps to facilitate this. The broad contours of the New Fuel Supply Agreements (FSAs) have been worked out, though some thorny issues such as price pooling of imported and domestic coal are still to be resolved. These pending issues must be solved quickly. Similarly, a debt restructuring package for the discoms has been worked out. The private sector must seize the initiative and rekindle the Schumpeterian spirit at this juncture. Banks also need to perform their core banking business while balancing risk assessment with the functional need to support growth.

We also need to harness our natural resources much better. Take the simple example of water. We are a country blessed with water resources with a network of perennial rivers and abundant rainfall. The rainfall provides four times the water that we use annually. Yet, water is a scarce resource in India. We haven't harnessed our resources enough and haven't planned the storage and distribution of water efficiently. India's per capita storage capacity is significantly lower than that of other countries. For example, the quantum of water that can be stored as a proportion of average river runoff for India is just 50 days of average runoff with wide variations—from 220 days in the Krishna to just two days in the Brahmaputra/Barak Basin. The comparable figures for the Colorado River Basin and Australia's Murray-Darling Basin are 900 days while for South Africa's Orange River Basin it is 350 days. Better water management could radically alter the agriculture situation in India.

India also needs to utilise its mining, spectrum and air resources better. The importance of clean air is often not recognised. We need to strike a right balance between our development needs and environmental

Reserve Bank of India Bulletin January 2013 Volume LXVII Number 1



Publisher : Reserve Bank of India

Author : Reserve Bank of India