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Breaking Out of the Third World: India's Economic Imperative

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1. Introduction

Mr. Chairman, Ladies and Gentlemen:

It is a great pleasure to join you here today, an honor to do so following Finance Minister Sinha, and an especial pleasure to join my LSE classmate and friend, Aroon Purie, in celebrating the twenty-fifth anniversary of India Today. I remember Aroon saying when we were undergraduates that he planned to go home and found a national news magazine. I thought he was dreaming. And he was. But his dream has become an extraordinarily impressive reality. Long may India Today continue to inform, enlighten, and entertain us, and long may Aroon continue to take his dream to ever greater heights of achievement.

There is another reason I'm happy to be here today – I had begun to fear that I would never make it. Three times in the last year, I planned trips to India only to have to cancel them because of crises in other parts of the world. Now it is up to other people at the IMF to deal with those crises. I will shortly leave the IMF, the great institution in which I am proud to have served for seven years. But I am delighted that my last trip as a member of the IMF is to India.

We are meeting at a time of continuing uncertainty for the world economy. After a year during which unexpected weakness in global activity was exacerbated by the terrible events of September 11 and their aftermath, the world economy remains subdued and the outlook is still uncertain. But there are reasons for cautious optimism. Industrial production appears to have bottomed out in a number of

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countries, confidence is stabilizing, and global financial markets have strengthened. It is reasonable to expect that the global recovery will gradually take hold and spread as the year progresses, first in the US, and then Europe, and then the rest of the world.

Meantime, the environment for emerging economies like India remains less supportive than it was: the demand for exports is weaker, and the supply of capital less reliable – and to quote Governor Jalan, “Despite the relatively inward-looking nature of the Indian economy, it cannot remain insulated from these international developments.” This makes it all the more important that India take the right steps now to boost long-term growth, and to fulfill its economic potential.

I will begin today by placing India’s recent performance in context, recalling the progress that has taken place especially over the last decade. I will then turn to some of the economic challenges that confront the country and stand in the way of its breaking out of the third world.

2. Achievements and Challenges

India has made impressive progress over the 1990s:

- Economic growth averaged 6 percent a year, led by strong advances in the services sector. The IT industry has proven particularly dynamic and is now of global renown – and its success proves that India is perfectly capable of competing and succeeding at the top international levels.
- Poverty has fallen significantly, from 55 percent of the population in 1974 to an estimated 26 percent in 2000. During the nineties, the poverty rate is estimated to have fallen from 34 percent to 26 percent, clearly establishing the link between faster growth and poverty reduction. Measures of income inequality also declined during this period. As you know, there was a great deal of controversy over what actually happened to poverty during the last decade – but the fact of a major decline in poverty is now well established
- Other social indicators have shown similar improvements. Over the last two decades or so: life expectancy has increased from 55 to 63 years; the infant mortality rate has dropped from 108 to 70 per thousand live births; and literacy has risen from 45 to 68 percent for men and from 29 to 45 percent for women.
- The external position has also strengthened: since the 1991 balance of payments crisis, official reserves have risen steadily and now stand in excess of

six months of goods and services imports. As capital account developments play an increasingly important role, more attention is being paid to another indicator of reserve adequacy – the ratio of reserves to short-term debt. A ratio of one is regarded as reasonable. In India, reserves are more than four times the level of short-term external debt, an extremely safe level. External debt has declined to around 22 percent of GDP, and the current account deficit has been held to less than 1 percent of GDP in recent years.

The driving force behind these social and economic improvements was the ambitious reform program undertaken in the wake of the balance of payments crisis in 1991. The crisis was a painful but valuable wake-up call. The reform program that followed marked a new willingness to allow market forces the freedom to work. It included: significant industrial and trade liberalization; financial deregulation; improvements to supervisory and regulatory systems; and policies more conducive to privatization and foreign direct investment. These changes reawakened what Keynes called the “animal spirits” of India’s entrepreneurs, and gave a sharp boost to growth.

We should not underestimate what was achieved in the last decade of the last century. But neither should we take those achievements and those growth rates for granted. Or, to say the same thing in the words of the IMF’s unofficial motto, “complacency must be avoided”. Fortunately, there is widespread agreement within India that much more needs to be done if the country is to achieve its economic potential.

For one thing, the economic momentum achieved through the early part of the 1990s has not been maintained. Although the experience of the early nineties has led many to conclude that the potential growth rate is around 7 percent, recent experience has fallen short of that. Growth has been slowing since 1997. While a number of exogenous causes can be pointed to – droughts, high energy prices, the earthquake in Gujarat – it is more plausible to attribute the growth slowdown fundamentally to a slackening in the pace of reform. And weaker growth and policy slippages have undermined the fiscal position and prompted credit rating agencies to downgrade their assessments of India’s prospects.

For another, growth during the past decade has not been sufficiently broadly based. Despite the impressive performance of the services sector, industrial growth – which still has the greatest potential to provide high-wage employment for the 70 percent of the labor force still working in agriculture – has slowed sharply since the middle of the decade.

Perhaps most important, despite the impressive inroads that have been made recently, about 260 million Indians still live below the official poverty line.

Renewing the momentum of reform, and thereby broadening and reviving growth, is essential if India is to achieve its economic imperative of breaking out of the third world. As outlined by the Planning Commission, it will take growth rates of 8-9 percent over the next decade to reduce the poverty rate to around 11 percent. Per capita income levels in China and many East Asian countries, which were roughly comparable to those in India in the 1960s, are now much higher. That remains true despite the losses suffered in East Asia in the 1997/98 crisis, illustrating the long-term benefits of purposeful integration into the global economy.

3. Sustaining Stronger Growth

What has to be done to accelerate growth, to lead India from the Third World to the First? Let me start with a disclaimer. In some countries, a speaker from abroad can bring fresh analytical insights and experience to bear, and frame the domestic debate. That is not really the case in India. Indian policymakers know full well about the important impediments to stronger growth, among them poor infrastructure, a high cost of capital, and persistent fiscal imbalances – all of which have dampened investment spending by the private sector. In addition, growth is being hampered by relatively low rates of foreign direct investment and a tendency to waste precious tax revenues on unproductive subsidies rather than worthwhile investments in, for example, primary education and health care. All these obstacles, and more, need to be tackled.

Economic policy discussions in India are at a high level. Indian government commissions and reports are generally highly professional and highly relevant to the issues at hand. On the question of how to increase India's growth to 8-9 percent per annum – rates that are entirely possible at this stage of economic development – there is no better guide than the excellent report in February last year of the Prime Minister's Economic Advisory Council, which laid out an impressive and comprehensive agenda for second-generation reforms.

The Report groups those reforms under six headings: first, agriculture; second, industry and trade; third, social infrastructure – education, health, and the social safety net; fourth, economic infrastructure; fifth, financial sector reforms; and sixth, the fiscal situation. Much of what I will touch on is in that report, and in convincing detail. I will focus on five key areas: embracing globalization, structural reform in product and labor markets, education, strengthening the financial sector, and fiscal consolidation.

Embracing Globalization

First, globalization. The case for further opening the economy, and undertaking the reforms necessary to benefit from doing so, was made eloquently by the report of the Prime Minister's Economic Advisory Council. It argued that:

Globalization is an unavoidable process which is taking place independent of us. It forces us to cope with it. There is not room in a globalized world for an economy delinked from world trade and foreign investment. The truth is that if we do not reform rapidly, and position ourselves to compete, we will be marginalized. There is no divine dispensation that gives India alone the power to survive and prosper as an isolationist island in a globalized world.

I agree with the analysis, but if anything it is too defensive. It suggests that globalization is something to which India must reluctantly acquiesce. Rather, I believe that globalization is a process that over the past 50 years has contributed to a bigger rise in living standards for more people around the world than has been achieved in any other comparable period in human history. The process should be embraced, purposefully, cautiously, with the appropriate safeguards, but embraced nonetheless.

Take the critical area of openness to international trade. India has taken important strides in trade liberalization in recent years, including significant cuts in tariffs and the removal of quantitative restrictions. Those measures helped improve the country's economic performance during the nineties. But tariffs in India remain very high by international standards, and the authorities frequently resort to anti-dumping measures.

As with previous rounds of trade liberalization, there will be a significant payoff from moving quickly to further lower trade barriers. The Advisory Council Report last year suggested moving the average industrial tariff level from 34 percent then to the East Asian average of 12 per cent by 2005. The average tariff level in India has not fallen since then, but the target of 12 percent by 2005 still remains sensible.

India's cautious approach to capital account liberalization probably helped limit contagion during the Asian crisis, by containing short-term debt and limiting linkages between India's financial system and the rest of the region. However, there are many benefits to greater openness to capital flows, especially foreign direct investment. FDI in India is extraordinarily low, especially compared to China. That remains true despite the recent increases in foreign capital inflows.

FDI can play a very valuable role, transferring skills and technologies, with significant spillover benefits to the rest of the economy. During the last decade, FDI

in India averaged 1/2% of GDP; in China it was 5% of GDP. With private investment in India at around 15% of GDP, greater openness to FDI would permit a nearly one-third increase in private investment relative to GDP, and a significant increase in growth.

Structural and regulatory changes are required to boost FDI. As a recent survey by management consultants A T Kearney illustrated, a cumbersome approvals process, questions regarding the legal system, regulatory impediments to doing business, poor infrastructure, and a perceived slowdown in the pace of economic reform, have all worked to impede FDI.

For the rest, capital account liberalization should take place gradually, but steadily, as the financial system and fiscal policy are strengthened.²

Structural Reform

That brings me to the second key task for reviving growth in India: accelerating structural reforms in factor and product markets. Here too important steps have already been taken, including the deregulation of telecoms, various privatization commitments, and the dereservation of some industrial activities. But more remains to be done. Let me highlight four priorities, most of which have also been emphasized by the Prime Minister's Economic Advisory Council.

- First, industrial deregulation. Priorities here include eliminating preferences for small-scale producers, further easing constraints on foreign direct investment, streamlining regulatory procedures, and revamping bankruptcy legislation.
- Second, labor market reform: the repeal of legislation blocking layoffs in medium- and large-sized firms, as announced in Minister Sinha's last Budget speech, plus legislation to ease constraints on the hiring of contract labor.
- Third, agricultural reform. Controls on the prices, trade and movement of agricultural commodities should be abolished. A sharp reduction in the role of government procurement agencies and the dereservation of agricultural processing would also be sensible. The costs of the existing system are visible in the growth in government food stocks, which represent a significant drain on the fiscal accounts and which far exceed what is needed for food security.

² For a considered view of capital account liberalization, see Montek Ahluwalia, "India's Vulnerability to External Crisis: An Assessment", mimeo, December 2001.

- Fourth, reform of the power sector. This is primarily the responsibility of the states. But the central government can help – and it has already begun to take steps in this direction -- by making funding conditional on necessary reforms. For example, metering, energy audits, commercialization of distribution, and the raising of tariffs to economically sensible levels.

Education

In considering how to answer the question posed by the title of this session, I consulted Lee Kuan Yew's fascinating book, *From Third World to First*, which is the story of Singapore from 1965 to 2000. There could hardly be two countries more different than Singapore and India, and most of Lee Kuan Yew's prescriptions do not fit India's circumstances. But at least one of his key emphases – on education, on training, and on the development of talent – is surely no less important for India than for Singapore. Nothing can bring that point home more vividly than to repeat the data on literacy: *fifty four years after independence, literacy rates are only 68 percent for men and 45 percent for women. In China the literacy rate is 91 percent for men and 76 percent for women.*

As the Report of the Prime Minister's Economic Advisory Council noted:

Literacy is the first step towards empowerment. Universal primary education is an effective anti-poverty measure that promotes equity. The economic returns, both private and social, on investing in education are high. A World Bank (1995) review for Asia shows these to be 39%, 19% and 20% for primary, secondary and higher education, respectively. This was before the Internet. Now the returns would be much higher.

The Economic Advisory Council report presents in more detail what needs to be done.

Financial Sector Strengthening

If we have learned one lesson above all others from the Asian crises, it is the importance of a strong and well-regulated financial sector.

This means having prudential and supervisory systems in place to ensure financial stability. It means ensuring that governance in private financial institutions is strong enough to ward off political interference and ensure that decisions are taken for good commercial reasons. And it means making sure that the authorities take swift and effective action to deal with weak or insolvent institutions.

India has gone a considerable way in this direction.. Prudential norms have been tightened, bank capital bolstered, and the supervisory systems strengthened. India has also had the wisdom and self-confidence to submit itself to the scrutiny of a Financial Sector Stability Assessment. This is a diagnostic tool that draws upon the knowledge of experts in a variety of national and international institutions, led by the IMF and the World Bank, and which a growing number of industrial and developing countries have found helpful in assessing and promoting financial stability.

But, important weaknesses remain, and need to be addressed. The stock market scandal points to the need for further improvements in governance. Problems with UTI, the development finance institutions, urban cooperatives, and weak banks all underline the importance of strengthening supervision, governance, and mechanisms for the resolution of non-performing loans, which are high by international standards.

The government's commitment to reduce its ownership in the financial sector is welcome and should be pursued. But it is not at all clear that private investors will be willing to enter the sector, and strengthen it, so long as the government wishes to retain a controlling share in each institution. And there should be no illusions about the fact that government control over financial institutions has almost everywhere led to their progressive deterioration. This is a change that needs to be made, sooner rather than later, if the financial system is to do its job efficiently – particularly the job of financing investment, which is too low in India.

Fiscal Reform

Finally, let me turn to fiscal reform. At nearly 10 percent of GDP, India's general government deficit is among the highest in the world. As a result, general government debt has risen to almost 65 percent of GDP and all the consolidation since the 1991 crisis has been erased.

At this point you may be thinking: "We have heard this all before" and recalling Larry Summers famous comment that IMF stands for "It's mostly fiscal". But I make no apology for bringing it up. A deficit this large cannot be sustained and, in the words of my old friend and colleague Herb Stein: "When something cannot go on forever, it will stop". Unless convincing steps are taken to reduce the deficit in an orderly fashion, it will likely stop in a disorderly one with serious consequences for growth.

Even if borrowing at current levels were not to cause a crisis, it is already holding the economy back by crowding out private investment and imposing a heavy interest burden on the budget, using resources that could otherwise be directed to development needs.

There is widespread recognition of the need for action. The Fiscal Responsibility and Budget Management Bill, currently with Parliament, seeks to eliminate the revenue deficit over the medium term. This is welcome as far as it goes. But lasting fiscal stability will require harder budget constraints at the state government level, tax reform, reductions in subsidies and more rapid progress with privatization. Further, the so-called golden rule of a budget balanced on current expenditures has no particular analytic backing, and it would be more useful to focus on the overall deficit.

Effort on all these fronts is required and will no doubt take years to implement fully. But international experience suggests that the payoffs will be large in terms of macroeconomic performance and the economy's capacity to cope with shocks. The sooner action is taken – and sustained – the better. The plans for very gradual improvement in the nineties failed, and a more determined rate of reduction of the deficit would make more economic and political economy sense.

I have seen what happens to too many countries in the phase in which India is now – in which the government is borrowing heavily and few adverse macroeconomic consequences are visible – to take any comfort from the present fiscal situation. And in any case, there *are* adverse consequences even now, for too large a share of private saving is being used to finance the government rather than finance investment and contribute to growth.

4. Conclusion

The measures I have discussed today constitute a formidable reform agenda, one that would tax the political and technical skills of any group of policymakers. Many of the proposed reforms challenge the interests of privileged groups, and some could involve painful adjustments. But the long-term benefits far outweigh the short-term costs, and delay will only increase the costs further.

It can be done, and it must be done, if India is to fulfill its economic potential and not to fall further behind countries whose performance it should be able to match – for in the words of the Prime Minister's Economic Advisory Council Report “if we do not reform rapidly... we will be marginalized.”

Indeed, India as the world's largest democracy, home to a billion people, would also inspire many other countries if it were to undertake these measures, increase growth to the desired 8-9 percent range, and over the course of time, move out of the third world.

The challenge is a mighty one, but it is time for India to meet it. On a visit to India over a decade ago, I was asked how the needed reforms could be implemented. That is a tough question, one for Indian policymakers to answer in detail. But the answer I gave then remains valid today:

“Just do it.”

Let me conclude by saying that, sad as I am that this is my last appearance as an IMF official, I am very happy to say my farewells in this great country, among friends, on this wonderful occasion.

Thank you, and good luck.