

*Prospects of India in a Globalised Economy*

*By*

*Narendra Jadhav*

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## **Prospects of India in a Globalised Economy<sup>1</sup>**

**Narendra Jadhav**

I feel deeply honoured for the invitation from your esteemed institution to speak on the occasion of the Silver Jubilee Function of the Indian Electrical and Electronics Manufacturers' Association( IEEMA). It gives me great pleasure to be here among the elite and distinguished participants of this conference. I would be talking on a subject which is close to the heart of all of us, "Prospects of India in a Globalised Economy".

Globalisation is not a new concept altogether to India. We were part of the empire for several centuries and particularly in the late nineteenth and early twentieth century, we were significant participants to world trade. British policy kept the Indian economy open to more or less free foreign trade and investment since Independence. But that experience proved, beyond reasonable doubt, that free trade and investment though necessary, were not sufficient to reap the benefits of globalisation in terms of higher growth and standard of living. As a matter of fact, the negative influences of such openness resulted in the Indian economy's adoption of a closed economic model immediately after Independence in the 1950s, with stress of self reliance and equitable distribution of income. While the closed economy model proved to be useful in industrial development and agricultural self sufficiency, it led to relatively lower global participation. Over time, particularly since the 1980s, Indian reformers had the growing realisation that the economy was performing at sub-optimal levels, and East Asian countries and China was racing ahead in comparison to our "Hindu"

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rate of growth. The crisis in early 1990s pushed us towards economic reforms, which has so far been gradual, but steady.

The experience of past one and a half decades shows beyond doubt that we are in a phase characterized by increasing globalisation. The present juncture proves great opportunities as well as enhanced risks. Globalisation is a double edged sword, it can lead to very high growth and at the same time can expose the economy to greater economic and financial volatility. Understanding the unique dimensions of emerging economies is critical to the success of Indian economy.

In the recent past, there have been dramatic transformations in the international perceptions about the Indian economy. International economic agencies and analysts are terming India as the economic powerhouse of tomorrow. The growing global interests in India and the perceptions of the global community towards India are reflected through the numerous reports published by international financial institutions and private corporate entities alike. These reports vindicate India's growing economic potential as it integrates into the global economy. The BRIC Report of Goldman Sachs argues that India has the potential to grow fastest among the four BRIC (Brazil, Russia, India and China) countries over the next 30 to 50 years — higher than 5 per cent over the next 30 years and close to 5 per cent as late as 2050. Recently, during his visit to India, Mr. Rodrigo de Rato, Managing Director of the International Monetary Fund stated, "Globalization is a much-discussed theme. But I believe India is the perfect venue to bring to it a new perspective. For India recently has grasped firmly the opportunities of globalization". Mr. Raghuram Rajan, Economic Counsellor and Director of the Research Department of the International Monetary Fund highlighted, "The stars are well aligned for India to become a hub of globalization". The McKinsey Quarterly in a Report titled 'A richer future for India' says, "India's competitive intensity could give it a better position than China to serve as a global low-cost auto-manufacturing base".

Equally important in this process is a very crucial intangible change that has taken place in this country – the change in the mindset of the Indian about what country and the people can achieve. Reflecting this newfound confidence, as Governor Reddy mentions, today Indians consider 6 per cent rate of growth as the inertial rate of growth. This changed mindset has enabled India to achieve various feats including becoming the most competitive steel producer in the world, the most preferred centre for cross-border outsourcing of high-end services activities and one of the most preferred destination for foreign investment.

As pointed out by Governor Reddy (Reddy, 2004),<sup>2</sup> the debate on globalisation has customarily been on the contours of the public policy on increasing global economic integration in the Indian context. In order to chart out the new course for the emerging India in the world economy, a necessary small step is to know where the country stands globally on a large range of issues. That is the focus of this note. The note traces India's relative positions in the world economy in terms of indicators on macroeconomy, infrastructure facilities, human developments, institutional and regulatory developments and competitiveness.

## **II. Benchmarking Indian Performance in the Global Economy so far**

### **Impressive Growth Performance**

Let us look at a set of indicators about India's performance in the rest of the world. The scorecard, I must warn you is full of promises and also challenges. A significant plus in India's performance is the growth rate. In terms of gross domestic product (GDP) – conventional, PPP and per capita – India has made strong progress since the 1980s and improved its global rankings. At constant US dollar terms (2000=100), India's average GDP during 2001-03 at US \$ 508 billion was 14th largest

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<sup>2</sup> Reddy, Y. V. (2004): *India and the Global Economy*, (July).

in the world (Table 1). The size of the Indian economy was US \$ 179 billion in 1981-85 and India economy ranked 17th in this period. Along with improvement in the position of the Indian economy in the world in terms of size, the share of India in the global GDP has increased continuously from an average of 0.96 per cent in 1981-85 to 1.55 per cent in 2001-03. In terms of PPP, India's global income share increased from an average of 3.76 per cent in 1981-85 to 5.77 per cent in 2001-03. It may be pointed out that the increase in India's share in global GDP by 2.01 percentage points between 1981-85 and 2001-03 is second only to China.

Despite being one of the fastest growing countries with stable growth process, India's per capita income continue to be only a fraction of the global average. Nevertheless, India's per capita income in constant US dollar doubled between 1981-85 and 2001-03 while the global per capita income increased by only 30 per cent during this period. Despite this, even in 2001-03, India's per capita income was equivalent to only 9 per cent of the global average and 2 per cent of the per capita income of the high income countries.

### ***Buoyant Real Economy***

In line with the global trend, the sectoral composition of GDP in India has transformed over the last two decades making the services the most important sector, followed by industry and agriculture. However, as compared to global standards, the share of agriculture in GDP remains much higher in India and those for industry and services remained lower than the global average. A comparison of India's sectoral growth performance over the last two decades with the world economy shows that with respect to industry, manufacturing and services, during 1981-2003, India systematically outperformed the global economy. India's agricultural growth also was higher than the global average during the 1980s and also 2001-03. During 2001-03, among the total sample of 178 countries, India ranked 55<sup>th</sup> in terms of agricultural

growth rate, 53<sup>rd</sup> for industrial activities, 43<sup>rd</sup> for manufacturing activities and 13<sup>th</sup> for services activities .

### ***Stable Inflation***

Another positive aspect of reform in India has been low and stable inflation. By the standards of EMEs, inflation in India has been relatively low and less volatile and the rate shows a declining trend since the 1990s. After a rise in consumer price inflation (CPI) from 8.4 per cent during 1986-90 to 10.5 per cent in 1991-95, the level declined substantially thereafter and remained at 4.9 per cent in 1996-2005.

Despite strong increase in the 1990s, market capitalisation in India as a proportion of GDP remained at 31.7 per cent in 2001-03, which is much lower than the global average of 84.7 per cent. The ratio in India is much higher than that for low-income countries and comparable with the middle-income countries. During 2001-03, India ranked 49<sup>th</sup> among 106 countries in terms market capitalisation to GDP ratio. Realising the strong growth prospects in India, there has been distinct increase in investor interest – both domestic as well as foreign – in the Indian securities market. This is reflected in the fact that stocks traded as a percentage of GDP increased from 8.0 per cent in 1991-95 to 54.7 per cent in 1996-2000 and turnover ratio increased from 31.2 per cent in 1991-95 to 63.7 per cent in 1996-2000 and further to 185.3 per cent in 2001-03. India ranked 14<sup>th</sup> in terms of stocks traded as a percentage of GDP during 1996-2000 and the country ranked 4<sup>th</sup> in terms of the turnover ratio in 2001-03 .

### ***Strong External Sector***

While during the reform process the wedge between the global and Indian export-GDP ratio has narrowed down, export-orientation of the Indian economy still remains one of the lowest in the world. In 2001-03, India ranked 176<sup>th</sup> among 187 countries in terms of export orientation (Table 6). During 2001-03, the export-GDP

ratio in India was 14.4 per cent while the import-GDP ratio stood at 15.2 per cent. During this period, the export-GDP and import-GDP ratios were 15.2 per cent and 13.6 per cent in Brazil, 29.6 per cent and 26.9 per cent in China and 34.4 and 22.9 per cent in Russia. It is, however, pertinent to note both that trade openness of larger economies is generally lower than smaller economies. For instance, the export-GDP and import-GDP ratios were 10.0 per cent and 13.8 per cent in the US and 11.0 and 10.0 per cent in Japan during the comparable period. India's export growth rate improved substantially since the initiation of the reform process. India's export growth rate was only 1.1 per cent in 1981-85; however, it increased to double digits since the 1990s. Consequently, India's global ranking in terms of export growth improved from 89th among 134 countries in 1981-85 to 26th among 173 countries. Consequent upon greater export orientation and higher export growth rate as compared to most other countries, India's share in the global exports increased from 0.52 per cent in 1986-90 to 0.94 per cent in 2001-03. From being the 34<sup>th</sup> largest exporter in 1981-85, India has become 27<sup>th</sup> largest exporter in 2001-03. Despite having relatively low import orientation, India's import growth rate since the 1990s has been substantially higher than the global average as well as growth rates registered by most of the EMEs including those from East Asia. In terms of import growth India ranked 42<sup>nd</sup> among 172 countries during 2001-03.

The quantum of net capital inflows to the country showed successive increases over the last two decades. While even before initiation of reforms during 1986-90, India ranked 2<sup>nd</sup> among the 110 EMEs<sup>3</sup> in terms of net capital inflow, apart from increase in quantum, the composition of capital inflow to India has undergone a transformation. In line with the stated objectives of the Indian authorities, the proportion of debt creating inflows have declined and that of non-debt creating flows have increased. In 2001-03, India ranked 6<sup>th</sup> among 135 countries in terms of net capital inflows. In line with India's efforts to emerge as a major destination for

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<sup>3</sup> For most of the indicators on cross border capital flows, the World Bank database does not provide details for high income countries.

foreign direct investment (FDI), India's global rank in this regard improved from 124th in 1986-90 to 18th in 2001-03. While there is a general consensus that the quantum of FDI inflows to India remains much lower than the potential for the country, various steps are underway to increase such flows. In the recent years, the buoyant equity market in India has attracted large portfolio investment inflows. From being the 5th largest recipient of portfolio investment inflows among 136 EMEs during 1991-95, on an average basis, India has emerged as the largest net portfolio investment receiving EME during 2001-03.

### *The Challenges*

#### *Infrastructure*

India's relative global position in terms of infrastructure facilities indicates three main points. First, infrastructural constraints continue to be one of the major impediments faced by the Indian entrepreneurs. There are identifiable large gaps in infrastructure facilities in the country. On account of efficiency and quality considerations and perhaps more importantly due to lack of resources, large scale public financing of such facilities is not feasible. Despite increasing the role of private including foreign investment, initiating of public-private partnerships and putting in place innovative funding options, such funds are not coming in the required scale for various important infrastructure facilities. Second, progress in improving infrastructure facilities has been uneven across various infrastructure facilities. So far, under the liberalisation process, greater success has been achieved with respect to information technology, telecommunication, roads and ports. The level of success has not been as marked with respect to areas such as power and railways. Three, despite having one of the largest infrastructure facilities and networks in the world (such as in terms of electricity production, road network, number of sea ports), per capita availability of such facilities and the quality of such services lag considerably

behind not only the industrialised countries but also EMEs from East Asia and Latin America.

Private sector performance in India faces a range of bottlenecks due to poor quality of infrastructure. The power supply position continues to be a constraining factor for the Indian industry. In spite of a series of reforms in power, there are huge transmission and distribution losses. State Governments need to play a significant role in accelerating reforms in this sector. Similarly, despite having a large road network, there is a lack of quality roads except for a few quality stretches. Radical changes are, however, underway. Smooth, pristine roads are coming up, connecting major cities, providing traffic flows of more than 90 kilometres per hour. India is witnessing one of the world's largest road building projects with huge investment of Rs. 650 billion with participation of Government, World Bank and Private sector. Similarly, port sector capacity needs to be enhanced with adequate participation of the private sector. In the telecommunication sector, India has made a considerable progress with increased participation of private sector. Progress is evident in terms of improved teledensity and increase in main lines per 1000 in the recent years. I am sure, you are very much aware of these challenges, and in fact, can educate me on a number of technical aspects.

### *Human Development Indicators*

Unless we improve the human development indicators, the fruits of reform will not percolate to the weaker segments of the population. Assessment based on human development indicators published annually by UNDP suggests that India has been persistently improving on various aspects of human development and is placed along with the countries falling under the category of 'medium human development'. However, the pace of progress seems to be slow, particularly in the areas of education and health. India's rank in terms of human development index and gender development index continues to be low compared to even some countries of South

Asia. The magnitude of social spending on sectors like health and education is far lower than the cross-country levels. This is evident from infant mortality rate in India, number of hospital beds per 1000, number of physicians per 1000, which are still not comparable with advanced economies and some of the EMEs. Although India's growth performance has been robust in the recent years, but it is important to note that growth without development will deepen inequality. There is a need for linking growth with development and fill the gap between macroeconomic performance and social sector development. A significant percentage of population is still unable to access the improved sanitation facilities and water sources. The National Common Minimum Programme has accorded high priority to social sector development by encouraging people's participation in the development process. However, the impact of such programmes can be expected only in the medium to long run. Since most of the social sector programmes fall under the jurisdiction of State Governments, their participation in implementing the programmes is very critical .

#### *Institutional Development in the Financial Sector*

The Indian financial sector has witnessed tremendous improvement in its performance as compared to other emerging market economies. Substantial cost-efficiency and profitability has been achieved in the post reform period. Although bank financial strength index for India is quite lower than advanced countries but it is definitely better than many major emerging market economies like China, Korea, Brazil, Argentina and Indonesia. The regulatory framework and supervisory practices have almost converged with the best practices elsewhere in the world as is evident from the fact that minimum capital to risk assets ratio has been kept at nine per cent, which is one percentage point above the extant international norm .

Convergence to the global standards by the Indian banks is evident from the fact that India has complied with almost all the core principles of Effective Banking Supervision of the Basel Committee and commercial banks in India will start

implementing Basel II with effect from March 31, 2007. Apart from this, some of the Indian banks are maintaining their accounts as per the Generally Accepted Accounting Principles in the US. According to the Indian Banks' Association Report on Banking Industry Vision 2010, the presence of global players in the Indian financial system is likely to increase and simultaneously some of the Indian banks would become global players in the coming years. As the process of mergers and acquisition gathers momentum in the Indian banking sector, some of the Indian banks may emerge as world-class banks with operations at the global scale. Presently, there are twenty Indian banks including a private sector banks which appear among the "Top 1000 World Banks" as listed by the London based magazine "The Banker". Among the top 100 global banks, India has only one bank, i.e., State Bank of India (SBI) which ranks 82<sup>nd</sup>, whereas China has 4 banks in the top 100. In terms of size, Indian banks including SBI are far behind the top banks in the world. However, the financial strength of the Indian banks is among the highest in Asia (Table 11).

Other segments of financial market, particularly, Indian stock market is also comparable to the international stock markets in terms of turnover ratio. Presently, India has third largest investor base in the world. Indian Stock market trading and settlement system are of world class. India has one of the world's lowest transaction costs based on screen-based transactions, paperless trading and a T+2 settlements cycle. At the end of 2003, Standard and Poor's (S&P) ranked India 17th in terms of market capitalization (19th in 2002), 16th in terms of total value traded in stock exchanges (17th in 2002) and 6th in terms of turnover ratio which is a measure of liquidity (7th in 2002). India has the number two ranking in terms of listed securities on the exchanges second only to the USA. Despite having a large number of listed companies on its stock exchanges, India accounted for a meagre 0.96 per cent in total world turnover as compared to that of the US at 52.4 per cent of worldwide turnover in 2003. In terms of market capitalization, Indian companies accounted for 0.87 per cent of the worldwide market capitalization while US accounted for 44.7 per cent in 2003. These data, though quite impressive, do not reflect the full Indian market, as

S&P (even other international publications) does not cover the whole market. For example, India has more than 9000 listed companies at the end of March 2004, while S&P considers only 5,644 companies. If whole market were taken into consideration, India's position vis-à-vis other countries would be much better.

### *Competitiveness Indicators*

India's competitiveness *vis-à-vis* other EMEs has improved in the recent years as measured by various competitiveness parameters. In terms of competitiveness rankings compiled by various international institutions, though India is way behind some of the developed economies, the country could put up a better performance than various other EMEs in the last few years. In terms of growth competitiveness ranking, India has overtaken countries such as Argentina, Indonesia and Brazil over the last four years, though it lagged behind its main competitors like China, Thailand, Malaysia, and Korea. The index of India's macroeconomic environment has improved from 59 in 2002 to 52 in 2004. On the other hand, the index for China declined from 6 in 2001 to 38 in 2002, but improved to 24<sup>th</sup> in 2004. The other EMEs of Asia, including Thailand (23), Indonesia (63) and Philippines (69) have also witnessed steady declines in their ranking over the last few years. Similarly, in terms of Business Competitiveness Index ranking also, India has improved its ranking over the years .

As per IMD's world competitiveness rankings 2005, India has been ranked as a more competitive economy than Indonesia, Argentina, Mexico, Brazil and South Africa. In terms of BCI ranking, India has been placed comfortably at the 30<sup>th</sup> position in 2004, which is much higher than many countries in Asia including China (47), Indonesia (44), Thailand (37) and Philippines (ranked 70). India's ranking is also much higher as compared to the EMEs in Latin America including Argentina (74) and Brazil (38). The higher ranking of India could be attributed to both its higher company operations and strategy ranking and the quality of national business

environment ranking. Since 1996, India has overtaken both Argentina and Brazil in IMD's world competitiveness ranking .

In the ensuing years, India's competitiveness will further strengthen due to its strong macroeconomic environment, improvement in productivity, enrichment in technology upgradation and increasing its trade share.

### ***III. Opportunities and Risks in the Global Economy***

The positive news about the global economies the process of global recovery is gathering momentum. The performances of China and India were the focal point of the global growth story. The growth performance of both China and India were influenced by strong domestic demand and large increases in both exports and imports. Looking forward, global economic activity is projected (by the IMF) to grow by 4.3 per cent in 2005 buoyed by strong corporate performance, accommodative macro policies and favourable financial market conditions. According to IMF, inflation is projected to remain moderate at around 2.0 per cent in advanced economies and 5.5 per cent in other emerging market and developing countries during 2005, although the movement in oil prices may alter the calculations.

Globally, financial markets have remained exceptionally accommodative with low interest rate and tight spreads. There has been an improvement in the resilience of the global financial system driven by robust global growth, buoyant financial markets and improvements in balance sheets of households/corporates in several countries. The stability of the financial sector has been maintained . Profitability of financial institutions has improved and the capital base of banks have strengthened due to improved risk management practices and lowering of corporate defaults.

Private capital flows to emerging market and developing countries have been strong in 2004 mainly contributed by modest recovery in private direct investment. Asia continued to be a major recipient, driven by flows into China. Latin America also witnessed a significant increase in capital inflows, mainly in Mexico and Brazil. In these countries, FDI flows were boosted by increased cross-border merger and acquisition activity in the banking and manufacturing sectors. These positive developments are reflected in the improved macroeconomic fundamentals, including well-grounded inflationary expectations, improved corporate balance sheets and reduced external vulnerabilities in emerging market economies.

### **Major Risks to the Global Economy**

Despite continued global expansion, benign inflation conditions, accommodative financial markets and robust financial system, there are several downside risks in the near term. These could take the form of sharp exchange rate volatility, sharp rebound in interest rates, continued weakness in euro area and Japan, and further rise in commodity and oil prices. Moreover, global imbalance, fiscal weakness in a large number of countries and structural weaknesses are longer-term downside risks facing the global economy. These 'soft patches' in the global economy warrants our attention as we are no longer spectators to the shocks emanating from global imbalances. Let me highlight a few of the global developments that pose risks to the Indian economy. Let me add that while the Government of India and the Reserve Bank of India are trying to protect the Indian economy from adverse shocks through a variety of policy initiatives, there is a need for market participants to strengthen their risk management framework in their own interest.

The major short-term risk that we see is rising and volatile oil prices. Robust global growth, persistent high demand for oil and inadequate spare capacity kept the annual real average price of oil at around US \$ 40 a barrel during 2004. According to IMF, the real average oil price rose by 74 per cent during June 2003 and March 2005. Although the current level and recent increase in oil prices are lower than during the earlier oil price shocks, the current expectations are that such prices are likely to remain high and volatile in the medium-term due to high demand, tight supply situations and susceptibility to shocks. The persistence of high oil prices may have a bearing on the growth performance of oil importing economies such as US , China, and India.

The disparity in growth performance across the major economies is also reflected in further deepening of global imbalances. Over the last few years, there has been a widening of divergence in regional growth patterns. While growth in US has been strong, supported by higher investment and consumer demand, in the euro area, business sentiments remain fragile and consumer demand sluggish mainly on account of faltering exports and weak domestic demand. In Japan, growth prospects have improved with a revival of consumer demand. Growth rates in Asian EMEs are likely to remain strong aided by various factors including strong domestic demand and liberalisation of textile trade.

The issue of global imbalance essentially hinges on an interdependent cycle. The US current account deficit is estimated to be 5.7 per cent of GDP in 2004 matched by current account surpluses in emerging Asia, Japan and the oil producing Middle-East countries. So far, US deficits have been financed by foreign investors with steady demand for debt securities of US. Secondly, fiscal deficit of US continues to remain at historical high levels. Moreover, the net savings of the US economy continue to remain quite low, at around 1.5 percent. With its rising budget deficit and ballooning current imbalance, US is running up a foreign debt of such high proportions that could threaten the financial stability of the global economy. Given

the central role of US in world output growth, even an orderly adjustment in US current account deficit may suppress the global output growth. The twin deficits in the US economy thus present a challenge not only for the US economy, but also to the rest of the world.

The issue of global imbalance is gaining in importance as the cost of the adjustments required by global players may become higher when the adjustment is postponed for the future. An orderly adjustment of global imbalances calls for a coordinated and cooperative approach among the major economies of the world. The US, the euro area and the Asian economies like China and India have major role to play in correcting these imbalances. Key elements of this coordinated approach should include different policy responses in different countries/regions. In the US, there could be a need to curb household and government borrowings and strengthen national savings. However, US policies would need to delicately balance a gradual withdrawal of fiscal stimulus without hurting the recovery and, at the same time, without disruptive adjustment of the US dollar. The Euro area, which continues to depend largely on external demand, needs to pursue some structural reforms, especially labour policies, to boost domestic demand and broad-base the recovery. Japan needs to continue to take some concrete measures to strengthen its financial system, restructure the corporate sector, and reduce large fiscal imbalances. There is a growing perception that flexibility in exchange rate policies in emerging market economies (EMEs) in Asia is worth considering on pragmatic grounds but as appropriate to each country's circumstances.

On the monetary policy front, the global policy cycle is surely bound northward as both the industrialised as well as EMEs transit from the present soft policy stance to a relatively higher interest rate regime, *albeit* in a cautious and calibrated manner. In many emerging market economies, especially in Central Europe and Latin America, policy rates have been raised substantially. environment. Expectations regarding the gradual monetary policy tightening in US have provided a

firm anchor to financial markets. Monetary authorities in US, UK, Canada and New Zealand have been gradually tightening the key policy rates, but these are still below the rate of inflation and thus kept yield on long term bonds low. The timing and pace of adjustment of interest rates holds the key to global growth process in the long run.

#### **IV. India: Coping with Increased Global Linkages**

Over the years, India's commercial and financial linkages with the rest of the world have been increasing with trade liberalisation and openness on the capital account. This is reflected in the transmission of international impulses to the real sector and domestic financial markets. Trends in international prices have now significant influence on domestic prices. Indian corporates and institutions are increasingly accessing international markets with consequent asset diversification. Encouragingly, the growth performance has been coupled with productivity enhancements in several sectors in the economy, availability of high level of food stocks, and accumulation of large foreign exchange reserves thereby imparting stability to the economy.

##### ***International Oil Prices and Domestic Inflation***

With increasing globalisation, the risk of increased pass-through of global prices to domestic prices is higher. After reaching a peak of 8.7 per cent during end-August 2004 on account of hardening of oil and commodity prices worldwide, the WPI inflation receded subsequently and stood at 5.0 per cent at end March 2005. At present, the inflation rate is around 3.4 per cent. The inflation rate would have been higher but for successful policy interventions which included fiscal as well as monetary measures, and, more importantly, abstaining from full pass-through of higher oil prices has not taken place. A part of the impact of increase in global oil

prices on domestic oil prices was cushioned by other two stakeholders - Government of India (by reduction in excise and customs duties) and domestic oil companies. In the Indian context, the rise in international oil prices has, thus been shared among all the three major stakeholders. While it is well understood that domestic prices cannot deviate from international trends for long, the policy authorities will ensure that the pass-through of international to domestic oil prices is smooth and non-disruptive.

### ***Managing Capital Flows***

A number of studies have confirmed that financial globalisation can contribute significantly to promoting growth in developing countries by augmenting domestic savings, reducing cost of capital, transferring technology, developing domestic financial sector and fostering human capital formation. At the same time, however, it has been recognised that sudden and large surges in capital flows cause several concerns. Large capital flows could push up monetary aggregates, engender inflationary pressures, destabilise exchange rates, exacerbate the current account position, adversely affecting the domestic financial sector. Such capital flows can cause disruptions in domestic growth trajectories if and when such flows get reversed or drastically reduced. Volatility of capital flows, particularly portfolio flows and their consequent impact on the emerging market economies is an area of concern in the current milieu.

In India, the monetary conditions in the economy is driven by large capital flows. The absorption of these flows has expansionary impact on money supply with implications for price as well as financial stability. This necessitates the neutralisation of the expansionary impact of external flows. In general, apart from exchange rate flexibility and foreign exchange market intervention there are several other policy responses that can be used to manage large capital inflows. The Working Group on Instruments of Sterilisation constituted

by the Reserve Bank reviewed the various instruments used in India and in other countries and deliberated on the suitability of various instruments to the current conditions in India and possibility for deployment in the future. In the face of strong capital flows especially in the early part of fiscal 2004-05, a Market Stabilisation Scheme (MSS) was introduced in April 2004 to absorb liquidity of more enduring nature by way of sterilisation through issuances of Treasury Bills/government dated securities.

### **Financial Markets and Financial Stability**

With the ongoing financial liberalisation, a number of measures have been taken to widen, deepen and integrate various segments of the financial markets. In India, development of financial markets has been pursued essentially for bringing about transformations in the structure, efficiency, and stability of markets as also integration of markets, both domestically and with global markets. With increasing linkages with international markets, financial markets tend to be driven by the developments in the global economy. In the recent period, the financial markets in India have been generally stable, although interest rates have displayed some upward trend reflecting uncertainties in oil prices, upward trend in global interest rates and increasing domestic demand for credit. The money market and forex market continue to remain stable. There was evidence of increasing collateralisation of transactions and better alignment of interest rates in the money market. The equity market recorded its all-time high in March 2005. A strong macroeconomic outlook, positive investment climate, continued investment support by foreign institutional investors (FIIs), and encouraging corporate financial results are the main factors driving the market sentiment in the recent period.

The financial sector has acquired greater strength, efficiency and stability by the combined effect of competition, regulatory measures, policy environment and motivation among the banks. The way the Indian financial sector withstood the

contagion effect of the Asian crisis in the late 1990s is the reflection of the depth and resilience of the financial sector. Despite introduction of stringent accounting norms, there has been strengthening of banking sector during 2003-04 in terms decline in non-performing loans as well as improvements in capital adequacy position.

### **Robust External Sector Performance**

The external sector of the Indian economy has emerged as the most robust of all sectors. The openness of the Indian economy has increased. India's exports and imports have been increasing rapidly. The Indian exporters are no longer shy of competing with their rivals in any market. In fact, our exporters are going big way to export traditional as well as non traditional goods like cars to several markets. The current account of the balance of payments (BoP) had remained in surplus consecutively over the past three years (2001-04). In the face of large capital flows, India's foreign exchange reserves have reached US \$ 143.2 billion as on August 19, 2005.

So, India has exploited well the challenges emerging from globalisation and increasing linkages with the global economy. Our policies have been in line with these emerging challenges. I would illustrate how we have managed the economy during the last one year in the wake of these challenges.

### **Challenges to Policy Making**

In the face of increasing globalization and transmission of impulses from global economy to the domestic economy, I would dwell at some length on the challenges faced by us. I must admit that there were some difficult challenges faced by us during 2004-05:

(i) There was carry forward of excess liquidity in the system, that had to be mopped up to contain inflationary pressures;

(ii) The WPI inflation had accelerated beyond the anticipated level during the first half of the year coupled with high and volatile international commodity prices,

(iii) The South-West as well as North-East monsoons were deficient, and

(iv) The Government Securities market faced adverse reaction and selling pressures in the on account of sharp upward movement in interest rates towards the middle of the year;

In order to successfully manage these challenges, the Reserve Bank had to balance the considerations of growth, while containing inflationary expectations. Towards this direction, several steps were taken by the Reserve Bank and the Government of India during 2004-05 in a measured and calibrated manner. Some of the major ones were::

(i) The market was sensitized about the supply-induced nature of inflation and the differential behaviour of inflation at the producers' and the consumers' level;

(ii) In order to arrest the acceleration in inflation in the wake of rising oil and commodity prices, the Government responded with several fiscal measures including reduction in duties on petroleum products and steel;

(iii) With a view to sterilize capital flows, the Government also raised the ceiling of MSS from Rs.60,000 crore to Rs.80,000 crore;

(iv) The fixed reverse repo rate under LAF was raised by 25 basis points to 4.75 per cent (raised further to 5.00 per cent on April 28, 2005). However, the repo rate and the Bank Rate were left unchanged at 6.0 per cent .

(v) The CRR was raised by one-half of one percentage point to 5.0 per cent.

The financial markets responded positively to the package of measures and, consequently, interest rates stabilized, credit flow to the commercial sector remained

uninterrupted and the government borrowing programme could be completed smoothly.

Thus, while the economy has the resilience to withstand supply shocks, the upside risks do exist. As such, the inflationary situation needs to be watched closely and there could be no room for complacency on this count. The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active demand management of liquidity using the policy instruments at its disposal flexibly.

## **V. Emerging Challenges to Indian Business in the Changed Economic Environment**

Successful conduct of business in the changed economic setting is fraught with a variety of challenges that are needed to be addressed expeditiously. These challenges need to be clearly understood and appropriate defenses, be developed.

### **Improving competitiveness**

India's simultaneous movement towards a market economy and liberalization on the external front has multiplied manifold the challenges to the competitiveness of Indian enterprises. The task of transitioning businesses from a relatively protected environment to the rigours of a globalised market requires upgradation of capabilities to international standards. This implies a major change in mindset, backed by substantial investments in modernization, scaling up and skills upgradation. Business portfolios will, therefore, need to be rationalized and restructured for focused

attention so that the deployment of scarce resources is confined to those areas that best match organizational capability with market opportunity.

### **Challenges posed by information technology**

The explosion in the use of information technology is further facilitating the process of globalization by erasing geographical and political boundaries. Even as Internet based electronic commerce has opened up enormous opportunities for the relatively smaller Indian enterprises by facilitating instant access to the developed markets of the world, simultaneously, it is creating opportunities for global players to access the Indian market, therefore, exposing us to global competition.

### **Emphasis on Quality and Efficiency**

A key challenge for business enterprises today is the availability of multiple brands to choose from. Both in rural and in urban India, consumers are now being exposed to and are trying a wide variety of consumer durables and non-durables, which were once considered as luxury items. Business enterprises are expected to meet the ever changing and ever increasing consumer preferences to stay in the business. With increased competition for a share in the consumer's purchasing power in today's market environment, driving business growth much more than provision of just a product or service; but rather better quality product and most efficient service.

### **Implications of new Global Trade Agreements**

The WTO schedule for trade reforms is a challenging and compelling agenda for Indian industry. It is in this context there is an imperative need for the Indian business houses to rapidly restructure and relocate their operations in their preparedness to face competition and phase their transition from an era of regulation and protection to the fully globalised market successfully. Maintaining superior

competitive capability can alone guarantee sustainable growth and profitability of business houses. Each business house needs to make a Strength-Weaknesses-Opportunities-Threats (SWOT) analysis to evaluate their existing capabilities and make a realistic assessment of required capabilities to face the onslaught of the competition.

### **Smooth transition to a globalised business environment**

In the globalized setting, the need to strengthening and upgrading the structure of the business enterprise through appropriate restructuring is critical. There is a compelling need to rapidly reposition Indian companies through mergers and acquisitions to reap the benefits of synergy and support their successful transition from an era of domestic existence and protection to the fully integrated world market market. To address the multifarious challenges in the new economic order, the business enterprises need to evolve new strategies and drastically improve their 'business competencies'. Managing and adjusting the company to the multitude of risks and benefiting from the opportunities brought forth by globalisation is the need of the hour. Strategic planning alongwith sound risk management policies will be key to success of an organisation.

Finally, let me stress that the IEEMA has a major role as the growth process in the future will be technology driven. The better the technological infrastructure, the higher will be the growth impact of reforms. . There are several challenges to your profession, which have emerged in the context of globalisation of the Indian economy. There is an urgent need to scientifically explore the opportunities, challenges and threats emanating from the world economy to India. As we all try to adjust ourselves to the new global order, I am pretty sure that your contribution in terms of improving technology and infrastructure in the country will have a crucial bearing to the future growth performance of this Great nation.

**Thank you,**