



India

While the fallout from Asia's crisis has been limited, economic growth slowed down in 1997 because of weather-related factors and subdued demand. Infrastructure bottlenecks also played a role and will need to be alleviated to enhance India's future growth prospects.

RECENT TRENDS AND PROSPECTS

After a strong performance in 1996, when real GDP grew by 7.5 percent, growth slowed to 5 percent in 1997. Agriculture, which accounts for a little more than a quarter of GDP, grew at a robust rate of nearly 8 percent in 1996. However, delayed monsoons in some areas and unseasonable and heavy rainfall in much of the country resulted in a dramatic fall in agricultural growth, which stood at just 2.5 percent in 1997.

Industrial growth remained disappointing in 1997 at 6.5 percent, well below the target of 12 percent. Manufacturing growth fell for the second consecutive year, dropping to 5 percent, compared with 7.9 percent in 1996. Once again, both consumer goods and capital goods industries were affected. Continued slow growth in consumer demand, subdued export demand, and worsening infrastructure constraints—which by raising the costs of production have played a role in limiting demand—were the main factors responsible for the slowdown in industrial growth, although heightened political uncertainty was also a factor.

The government's 1997 budget was designed to continue the process of fiscal consolidation, while at the same time giving a strong push to growth, particularly in industry. In addition to substantial cuts in direct taxation, the budget also included a

range of other measures designed to boost savings and investment and revive the capital market. With government expenditure held constant in real terms, the budget also envisaged a further reduction in the fiscal deficit from 5 to 4.5 percent of GDP. This was based primarily on assumptions of improved tax buoyancy, although measures to improve tax compliance, as well as increased income from the disinvestment of government holdings in public enterprises, were also expected to contribute to the improved budget outcome.

However, with the economy, especially industry, failing to respond to the budgetary stimulus, revenues fell well short of the target, despite the success of the government's tax amnesty scheme. In addition, the government had to cut back its plans to sell off its holdings in public enterprises because of the downturn in global stock markets in the latter half of 1997. At the same time, the government's decision in July 1997 to grant major pay increases in excess of those recommended in the Fifth Pay Commission Report pushed expenditures well above budgeted levels. Even allowing for the impact of the government's supplementary budget, introduced in September to deal with the revenue shortfall, the fiscal deficit is expected to have risen rather than fallen in 1997. The increase in civil servants' pay will also contribute to the intense pressure on state governments' finances, because they are more or less

Table 2.13 Major Economic Indicators: India, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth ^a	7.2	7.5	5.0	6.7	7.0
Gross domestic investment/GDP	26.2	27.1	26.6	27.1	29.0
Gross national saving/GNP	24.4	25.6	25.5	25.6	27.1
Inflation rate (consumer price index)	10.0	9.2	6.5	7.0	7.2
Money supply (M3) growth	13.7	15.9	16.5	16.7	15.0
Fiscal balance/GDP	-7.1	-7.0	-6.7	-6.7	-6.5
Merchandise exports growth	20.8	4.1	5.0	7.5	7.8
Merchandise imports growth	28.0	5.1	8.2	9.9	11.2
Current account balance/GDP ^b	-1.8	-1.0	-1.2	-1.5	-2.0
Debt service/exports	37.3	41.9	31.8	29.9	28.9

Note: All data are on a fiscal year basis.

^a Based on constant 1980 factor cost.

^b Excluding official transfers.

Sources: Central Statistical Organisation (1998), Reserve Bank of India (1997), and staff estimates.

obliged to follow salary revisions made by the central government.

On a more positive note, the release of the *Government White Paper on Subsidies* in May 1997 has initiated more open debate on the subsidy issue and is expected to prompt substantial reform in the next few years. Total budgetary subsidies, both at the central and state levels, amounted to a massive 14.4 percent of GDP in 1994. Only about a quarter of these subsidies could be justified on the grounds that the market by itself would not provide the right level of output. Another important development was the government's announcement in the 1997 budget that, despite its continued fiscal pressures, as of 1 April 1997 it would discontinue the system of ad hoc Treasury bills as a means of automatic financing for the budget deficit. This move was designed to strengthen fiscal discipline while providing greater autonomy to the Reserve Bank of India (RBI) in its conduct of monetary policy.

Monetary policy was further eased in 1997 in an effort to complement the fiscal stimulus given to the economy by the budget and to prevent the rupee from appreciating as a result of strong capital inflows in the first half of 1997. Measures taken included further cuts in the cash reserve ratio and

the bank rate, which, with controls lifted on almost all deposit and lending rates, was reintroduced especially to signal the policy stance of the Central Bank. Despite the fall in lending rates, the amount of credit taken up by the corporate sector remained subdued because of lack of business confidence and the continued high real costs of domestic borrowing. Another factor was the persistent caution on the part of banks in appraising the riskiness of loans, a result of the stricter requirements of the RBI's new prudential norms. As business confidence began to pick up in the latter part of the year, credit uptake also began to increase. However, this may have been partially offset as the RBI tightened monetary policy in an effort to ease downward pressure on the exchange rate toward the end of the year.

While the scope for further improvements in credit appraisal and loan recovery is substantial, the banking system's performance continued to improve in response to financial sector reforms. The 27 public sector banks posted an aggregate profit of \$950 million in 1996, compared with a loss of \$110 million in 1995. The RBI intensified its supervision of nonbank financial institutions during 1997, particularly those that were sponsored by or had close links with particular corporate groups. In December the

government appointed the Second Financial Sector Committee to review the progress of financial sector reforms. The committee is expected to pay particular attention to the role and operations of all-India development financial institutions and nonbank financial institutions. The continued fall in inflation was one of the main bright spots of 1997, with inflation as measured by the consumer price index falling to 6.5 percent.

After rapid growth in both exports and imports between 1992 and 1995, the rate of growth fell sharply in 1996 and 1997. Exports are estimated to have increased by just 5 percent in 1997, while imports are estimated to have risen by 8.2 percent, although in both cases these growth rates are higher than in 1996. The major cause of slow export growth in 1997 was the fall in exports of primary products and garments. As in 1996, the slow growth in imports primarily reflected the continued slow growth of the industry sector, and hence reduced demand for imported capital goods. However, it also reflected a fall in crude oil imports because of increased domestic production. The current account deficit is estimated to have increased marginally to 1.2 percent of GNP.

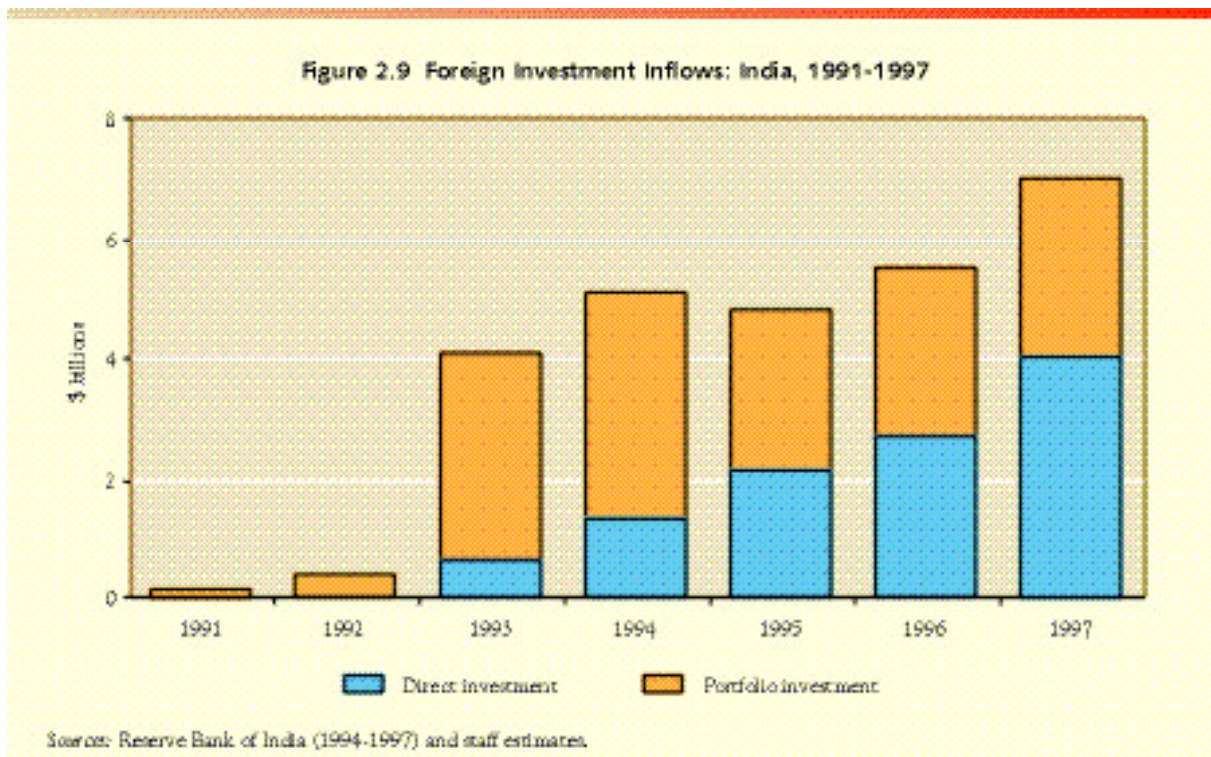
Inflows of foreign direct investment (FDI) increased to around \$4 billion, almost 50 percent more

than in 1996, while FDI approvals reached \$17 billion, compared with \$8.7 billion a year earlier. Although foreign portfolio investment in 1997 increased marginally over the previous year, net outflows of portfolio investment occurred in both November and December 1997 as a result of the worsening Asian currency crisis and the loss of confidence in the region's stock markets.

The economy is expected to grow by between 6.7 and 7 percent during 1998 and 1999 based on a recovery in both agriculture and industry. While the potential for a stronger recovery in industry exists, infrastructure constraints are becoming increasingly binding. With exports rising more slowly than imports, the trade deficit will widen, leading to a substantially wider current account deficit. In view of this, and in light of the Asian currency crisis, the authorities must try to ensure that India's exchange rate remains competitive.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

Apart from efforts to boost economic growth, particularly industrial growth, concerns about the exchange rate dominate economic management. While concerns in the first half of 1997 revolved



around the upward pressure on the rupee resulting from the then strong capital inflows, the focus of concern since around the fourth quarter of 1997 shifted to limiting the contagion from the Asian currency crisis. The RBI's initial welcoming of the weakening of the rupee in August and September 1997 was not surprising. However, from mid-December onward, the RBI began to intervene to defend the currency. The RBI introduced measures to defend the rupee after it hit an all-time low of Rs39.93 to the US dollar, and responded even more vigorously when the rupee fell below the psychologically important rate of Rs40 to the US dollar. As a result, the rupee appreciated to around Rs38 to the US dollar by the end of January 1998.

However, whether further weakening of the rupee would be undesirable is not clear. Given the massive devaluations that have occurred in Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand, the rupee is now significantly overvalued compared with these countries' currencies. While relatively few of India's exports compete directly with those of these countries, the currency depreciations have also increased their attractiveness as locations for FDI and tourism. Some further depreciation of the rupee may therefore be necessary to maintain India's external competitiveness. Moreover, some of the measures adopted to contain the rupee's slide, such as the increase in the cash reserve ratio by 2 percent in January, could choke off an industrial recovery by dampening business enthusiasm to borrow funds for investment. These considerations suggest that the authorities will need to weigh carefully the costs and benefits of supporting the rupee if it comes under renewed pressure during 1998.

POLICY AND DEVELOPMENT ISSUES

Although India has already made substantial progress in implementing economic reforms in recent years, the government will need to enhance both the scope and pace of economic reforms if it is to sustain the improved economic performance of the last few years. Among the many areas that need attention, infrastructure development is one of the most critical.

Serious infrastructural deficiencies present a major impediment to sustainable growth of the Indian economy, and are among the major contributors to the slowdown in growth in the last two

years. Estimates indicate that the level of investment in infrastructure needs to be increased by almost 50 percent in real terms during the next decade if India is to maintain GDP growth of at least 7 percent. Given the pressure on government capital spending, the private sector will have to come up with the bulk of the additional requirements. Projections suggest that the level of private investment would need to increase almost sevenfold per year, to some \$23 billion by 2007. Substantial scope for private sector participation also exists in industrial parks, ports, power, roads, telecommunications, and urban infrastructure.

However, the commercialization of infrastructure faces several major constraints, including the absence of an appropriate, long-term framework and policy incentive mechanism for private investment; the poor policy coordination among different government agencies in the implementation of large infrastructure projects; and a shortage of long-term funding. Although recent years have seen some progress, a number of critical issues need resolution.

Governments in developing economies have traditionally provided infrastructure services below supply costs, and India's government has been no exception. In the case of the power sector, net subsidies in India have been estimated to be around 1 percent of GDP. Even though the costs of private sector operations may be lower because of better efficiency, greater cost recovery through increased user charges is essential to ensure the viability and sustainability of the private sector. Unfortunately, any adjustment of prices and tariffs remains a sensitive issue, and setting user charges that are sufficiently high to provide adequate returns to the private sector, while ensuring that users do not perceive the charges as unfair, will be important.

Because of such factors as high costs, long gestation periods, and irregular revenue flows, infrastructure investments rely heavily on long-term debt financing. However, in contrast to equity markets, India's debt markets are not well developed and constrain infrastructure financing. One critical problem with the debt market is the thinness of the secondary market, which makes it difficult for holders of long-term debt to convert it into more liquid assets. This has served to reduce the attractiveness of holding long-term debt. One factor constraining liquidity is the stamp duty states impose on the issuance and trade of financial instruments. Stamp

duties are an important source of revenue for state governments and cannot be abolished. However, exempting the trade of financial instruments, particularly those relating to infrastructure funding, from these duties should be made possible in order to develop secondary markets.

In addition, institutional investors with a long-term investment horizon, such as insurance companies, provident funds, and pensions funds, are critical sources of long-term funding. Opening up this sector to greater competition and allowing the entry of foreign institutional investors will widen the investor base. Attempts to do this have, however, met with setbacks. The government had to back off from

its initial moves to introduce competition into health insurance because of opposition in Parliament, and the opening up of the insurance sector, especially to foreign companies, remains constrained.

While the private sector must increasingly take the lead in infrastructure development, it will be some time before the appropriate legal and regulatory frameworks are in place. In addition, public investment in basic infrastructure, as well as a strong public-private partnership in infrastructure development, are needed to increase private investment. Given the vital role that the public sector continues to play, any further cuts in public sector capital expenditure need to be carefully evaluated.