India

The recovery is being sustained, and the new government passed several important reform bills at the beginning of its term. However, the unfinished agenda of economic reform remains substantial. In particular, while reforms undertaken so far clearly have helped promote economic growth, progress has been less impressive in developing better social opportunities for the poor.

RECENT TRENDS AND PROSPECTS

The economic recovery that started at the end of 1998 continued in 1999, but at a slightly slower pace because of less growth in agriculture. GDP growth was slightly lower, at around 6 percent, than the 6.8 percent in 1998.

With below-normal monsoon in some areas and serious damage from a cyclone that hit the Orissa coast in October 1999, agricultural growth slowed from 1998's strong performance of 7.2 percent to less than 1 percent. However, lower growth in the agriculture sector was partially offset by increased activity in industry and services. Industrial output increased 6.5 percent in contrast to a 4 percent rise the previous year. Double-digit growth in consumer durables, machinery, and cement boosted the sector. Automobiles and steel production also continued to record healthy growth rates. The growth rate of the service sector, which had declined modestly in 1998, bounced back to the previous level of about 8 percent.

The primary concern of the Reserve Bank of India (RBI) in 1999 was to ensure adequate liquidity for the corporate sector while keeping inflation under control. Under the generally favorable policy environment, characterized by low inflation and a stable Indian rupee, the easing of monetary conditions continued in 1999, with the broad money supply (M3) growing at a comfortable 16 percent. The RBI managed the adverse effect of large government borrowing on interest rates with a blend of auctions, private placement, and open market operations. Sales of bonds to the private sector accounted for 40 percent of total government borrowing.

As the economy recovered in 1999, bank credit and other flows to the commercial sector increased. The RBI cut the cash reserve ratio three times, from 10.5 to 9 percent, and reduced the repurchase and bank rates by 2 percent and 1 percent, respectively. Consequently, bank credit to the commercial sector expanded 11 percent during the first nine months of 1999, compared with 7 percent the previous year.

1999 refers to fiscal year 1999/00, ending 31 March.

Nonfood bank credit increased 9.3 percent, in contrast to an increase of 6.2 percent in 1998. The annual inflation rate remained remarkably low during the first half of the year before rising slowly in the second half. Inflation in terms of the wholesale price index was 3.3 percent, compared with 6.9 percent the previous year. The consumer price index for industrial workers also dropped, to 5.3 percent from 12.9 percent in 1998.

The deterioration of the fiscal balances of central and state governments continued, despite the consensus among various levels of government that these imbalances urgently needed correction (see figure 2.14). The combined fiscal deficit reached nearly 10 percent of GDP in 1999, the highest level recorded since 1990. The states' component of the deficit recorded a new high. The gross fiscal deficit of the central government rose to about 5.5 percent of GDP in 1999 from the previous year's 5 percent. The fiscal deficit on states' accounts exceeded 5 percent of GDP. The deterioration in state's finances was not due as much as to a decline in revenues, as in the case of the central government, but a result primarily of sharp increases in wage expenditures.

The balance-of-payments position remained stable in 1999. Despite the surge in oil prices, the current account deficit was contained below 1.5 percent of GDP because of the solid performance of exports. With the rebound in Asia and recovery in the global economy, exports grew at more than 10 percent in dollar terms after a disappointing 3.9 percent drop in 1998. Manufactured products accounted for 80 percent of exports. Imports also recovered, growing at 9 percent for the year compared with 1998's 0.9 percent growth. The growth of imports was fuelled primarily by the substantial increase in the prices of crude oil and petroleum products, although this was partially offset by a decline in non-oil imports.

Encouraged by the improved economic outlook and increased political stability, foreign investment flowed in strongly, with $3.1 billion during the first nine months of 1999—almost three times as much as the $1.1 billion during the same period in 1998.

Table 2.15 Major Economic Indicators, India, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth[a]	5.0	6.8	5.9	7.0	7.0
Gross domestic investment/GDP	26.2	23.4	22.5	24.0	25.0
Gross domestic savings/GDP	24.7	22.3	21.0	22.0	23.0
Inflation rate (wholesale price index)	4.8	6.9	3.3	4.8	5.0
Money supply (M3) growth	18.0	18.4	16.0	17.0	17.0
Fiscal balance/GDP	-4.8	-5.0	-5.5	-5.0	-4.0
Merchandise exports growth	4.5	-3.9	10.0	4.5	5.0
Merchandise imports growth	4.6	0.9	9.0	7.0	8.0
Current account balance/GDP	-1.3	-1.0	-1.5	-1.8	-1.8
Total debt/GDP[b]	24.7	24.4	23.5	22.3	22.0

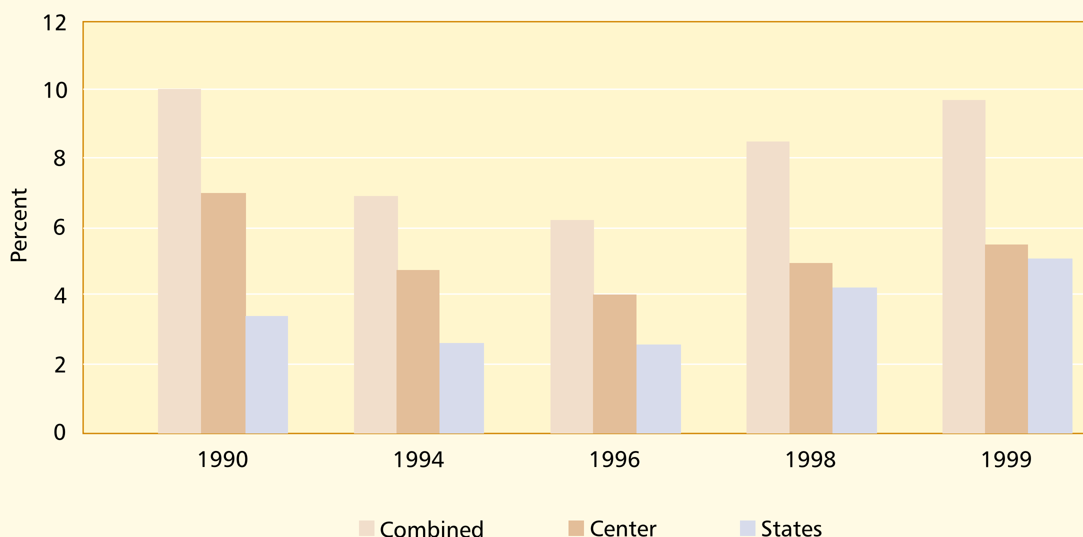
Note: All figures are on a fiscal year basis.

a. Based on constant 1993/94 factor cost.

b. At end-March.

Sources: Central Statistical Organization (1999); Reserve Bank of India (1998); Ministry of Finance (2000).

Figure 2.14 Fiscal Deficit as Percentage of GDP, India, 1990-1999



Note: For 1990-1999, positive percentage rates are fiscal deficit.
Source: Reserve Bank of India (various issues).

Portfolio investment turned around significantly, with $1.2 billion of net inflows in 1999 in contrast to $752 million of outflows the previous year. Foreign direct investment inflows fell relative to the previous year, from $1.56 billion to $1.19 billion. However, in a major policy decision in February 2000, the government granted automatic clearance for all foreign direct investment except in a few sensitive sectors. Foreign exchange reserves, except for gold and special drawing rights, were an estimated $32 billion (8 months of import equivalent), an increase of $2.5 billion from the previous year. The pressure on the exchange rate eased considerably, reflecting the revival of the Asian economies and a generally more favorable external environment. Consequently, the Indian rupee depreciated much less than it did the previous year.

With a significant slowdown of economic growth in recent years, concern exists that India may slip again into low growth. It needs to sustain 7-8 percent growth per year to make significant progress toward reducing poverty. However, with the encouraging outcomes of the election in late 1999, optimism is renewed concerning economic prospects. The new government has a significant majority and a forceful leader with a clear vision to carry out new structural reforms. Simultaneously, a recovery is being sustained, aided by a favorable external environment. Meanwhile, a global technological revolution is helping India benefit from its own “new economy” boom.

The status of public finance remains a serious cause for concern, but the government is addressing the problem via tax reforms and expenditure cuts. With continuing recovery in industrial production and the service sector, the GDP growth rate is projected to increase to 7 percent for 2000 and 2001. The balance of payments is likely to remain stable, with the current account deficit at 1.8 percent of GDP. Exports and imports will both grow more slowly, while the ser-

vices balance should remain relatively stable. Changes in regulation governing the inflow of foreign direct investment combined with a strong foreign interest in portfolio investment (particularly in technology stocks) is expected to further accelerate the inflow of foreign investment. The RBI will continue its effort to contain inflation at less than 5 percent per year, while providing sufficient credit to the productive sectors of the economy.

ISSUES IN ECONOMIC MANAGEMENT

During its first two months in office, the new government passed the first hurdle in implementing the next phase of reforms. The new insurance bill, which will open the insurance market to the private sector, is a significant first step. Nevertheless, the unfinished agenda of economic reform remains substantial. Reforms that have already begun—reducing protection levels, developing efficient financial and capital markets, and expediting public enterprise reforms—should be completed swiftly, preferably within a defined timeframe. In those areas where reforms have not yet gained momentum, such as fiscal consolidation, labor market, and power sector, it is urgent that these reforms be addressed.

Of particular importance is the need to expand the reform process to state and local governments. Indications are clear that the top levels of the government, as well as the corporate sector, are convinced of the urgency of carrying out economic reforms. However, most state governments and the lower levels of line ministries, which are directly responsible for implementing reforms, are neither fully aware of the urgency of the effort nor equipped to implement them.

Similarly, the capability of the system to put the proposed reform measures into action is also in serious doubt because of institutional weaknesses inherited from the past. The inefficient and oversized bureaucracy and the outdated and nonresponsive legal system are examples. Without efficient administrative and legal systems, the high transaction costs involved in processing the reform agenda will outweigh the potential benefits of reforms. Capacity building and institutional reforms are urgently needed to improve the processing of reforms.

POLICY AND DEVELOPMENT ISSUES

Both the political situation and the external economic environment have been volatile in 1995-1999. However, neither the frequent changes of government nor the financial crisis in East Asia had a lasting impact on the general direction of economic reforms. The consensus on economic reforms not only survived the four changes of government since 1996, but was strengthened through these changes. In terms of external economic environment, the adverse impact of the East Asian economic crisis on India's economy was limited. Sanctions imposed by G7 countries following nuclear tests by India and Pakistan in May 1998 added new uncertainties, but their effect has been marginal.

Although the broad direction of economic reforms has been maintained in recent years, there have been signs of reform fatigue. The initial urge and excitement generated by the reform process abated as the economy recovered from the 1991 crisis. Consequently, the ability of policymakers to make radical changes greatly diminished and special interest groups blocked the progress of reforms on several occasions.

With the slowing of reforms, it became evident that the growth impulses generated by the first generation of reforms had ebbed by the mid-1990s. Industrial growth significantly decelerated and export growth fell. Infrastructure bottlenecks began to hamper the expansion of private sector economic activities. Poverty, illiteracy, and lack of basic health care were aggravated by the worsening environment. The slowdown in GDP growth in 1997-1998 raises a serious question: does the economic slowdown reflect underlying structural impediments that could lead to lower growth if not tackled urgently?

At the core of the reform process lies the reorientation of the government's role to improve efficiency and raise the long-term economic growth potential. Traditionally, the government has controlled private sector activity through various licensing schemes and has produced important goods and services though public sector enterprises. Excessive intervention of government in economic activities was inefficient, however. Therefore, remaining reforms should withdraw unnecessary government in-

terference and refine the role of the state in economic management. Reforms must ensure that the private sector, not the government, is in charge of raising production, creating jobs, and increasing income levels.

Dependence on the private sector and markets does not mean that the government has no role. Reorienting its contribution to the economy is crucial, and government can help create conditions for accelerated growth. For instance, a sound macroeconomic environment—characterized by prudent fiscal policy, an efficient monetary and financial regime, and market-determined exchange rate policies—is essential to attract private investors. International rating agencies issued a warning in 1999 that the fiscal deficit had grown again to unsustainable levels during the past several years. Although there is yet no sign of imminent macroeconomic crisis, lack of fiscal prudence pushed up interest rates. This deters private investment and increases interest costs for government and private firms.

Second, infrastructure bottlenecks are likely to constrain the achievement of a higher growth rate of 7 percent and above. The infrastructure system is overstrained and suffered from underinvestment in the post-reform period. Massive investments will be needed in both public and private sectors to overcome these bottlenecks. A two-pronged approach is required: mobilizing private investment to supplement the public sector effort, and garnering public investment in the many sectors where private investment is difficult to mobilize.

Third, the poor state of human resource development is an even more serious constraint to sustainable development. Clearly, people will not be able to use the new opportunities offered by economic growth if they remain illiterate and lack the basic skills required by modern industries. Creating conditions for accelerated growth is not sufficient unless people are ready to participate in the growth process and use opportunities to integrate with the world market. Large investment in social sectors is therefore essential not only for social development, but also as a precondition for accelerating growth. One important aspect is the role of the states in undertaking remedial actions to rectify the poor social development record. Because state governments are responsible for social sector investments, fiscal reforms and restructuring at the state level are critical for increasing expenditures on the social sectors, particularly in primary and secondary education and health and sanitation.

Fourth, restructuring public sector enterprises through disinvestment or privatization must be accelerated. One positive development after the 1999 election was the acceptance of the notion of privatization. The ruling coalition advocated privatization in its electoral platform, becoming the first political party to use the word officially. With the dissolution of the Disinvestment Commission at the end of November 1999, the government set up its own committee to provide recommendations and modalities for privatization. This committee will be crucial if the coalition government takes advantage of improving economic conditions and its majority in Parliament to initiate a major drive toward privatizing some state assets.

The economic reforms undertaken have yielded good results, but progress has been less impressive in terms of better social opportunities for the poor. From the beginning of the reform process, the government tried to keep its commitment to traditional poverty alleviation programs that existed before the reforms. These included direct support to the poor by subsidized sale of food grains and kerosene, job-creating public works programs, and a variety of self-employment programs that provided small loans. However, the real issue has been the effectiveness of these programs. Recognizing high costs and minimal impact, the government considered phasing out some antipoverty programs and reallocating part of the savings to improve social services, especially health, education, and family welfare. This shift was motivated by the recognition that a fresh perspective is probably more effective than marginal expansions in traditional schemes.

The government needs to spend more in education and health, but not only because investments in human capital are instrumental for economic growth. While education and better health clearly have value in making people more productive and generating more outputs and incomes, the elimination of illiteracy, ill health, and other depriva-

tions are valuable for their own sake. The adverse effect of persistent illiteracy, for example, goes beyond limited economic opportunities. It constrains a person's freedom and well-being, and has a direct role in the relative deprivation of women in particular. It sustains high mortality and fertility rates. It also contributes to the comparative lack of pressure for social change, and to the weakness of political demand and pressure for effective public attention in fields such as health care.