

India

Economic Assessment

GDP growth more than doubled to 8.2% in FY2003 (ended 31 March 2004) from 4.0% in the previous year (Figure 2.14). The upturn was also broad based. In FY2004, economic growth is forecast to moderate, but remained high, due to the impact of delayed monsoon rains in large parts of the country and devastating floods in other parts in the first 4 months. These natural calamities will contain agriculture sector output and private disposable income. Higher world oil prices will also act as a drag on the economy.

The exceptionally high agricultural expansion of 9.1% in FY2003 represented a significant jump in output, exaggerated by the drought-driven decline a year earlier. In FY2004, delays in the monsoons and a highly skewed rainfall distribution pattern across the country are likely to have an adverse impact on agriculture and keep the expansion below trend. In the industry sector, the previous year's high momentum was sustained: following 7.2% growth in FY2003, manufacturing production picked up further to 7.9% in the first quarter of the current fiscal year (April–June), spurred by high growth of capital goods, intermediates, and consumer durables. The broad-based manufacturing growth was supported by solid growth in key infrastructure industries, such as energy.

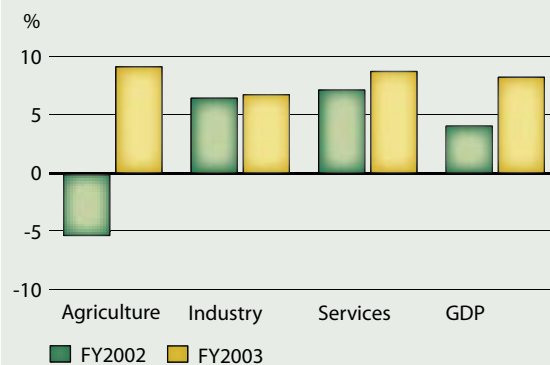
Services sector growth at 8.7% in FY2003 was significantly higher than in the previous year and ongoing developments suggest continuing healthy performance in FY2004. The dynamism in this sector in recent years has stemmed from high income elasticity of demand and domestic reforms, coupled with high productivity in certain subsectors and improved access to the global market. Unfortunately, employment growth has remained limited despite the acceleration of overall output growth. This issue of

“jobless” growth is a major challenge, and was discussed in *ADO 2004*.

In FY2003, the consolidated deficit of the federal and the state governments showed a marginal improvement, declining to 9.4% of GDP from 9.5% a year earlier. Nevertheless, the deficit is still very large compared with those in other major developing countries. In fact, the improvement masks a worrying disparity: it came entirely from the federal government side, since the finances of state governments deteriorated further. Total public debt amounted to 76.7% of GDP at end-FY2003, with interest payments in the year equal to 34% of revenue receipts (or 6.5% of GDP) and so crowding out public development expenditures. Accordingly, fiscal consolidation remains a major macroeconomic and developmental challenge.

Money supply (M3) grew rapidly at 15.5% year on year as of 20 August 2004, significantly higher than 11.9% growth registered in the same period of FY2003. This largely reflected the continuing rise in foreign exchange reserves at the Reserve Bank of India (RBI) and the consequent expansion of the monetary base. Credit conditions

Figure 2.14 Sector Composition of Growth, India, FY2002 and FY2003



Source: Compiled from www.mospi.nic.in/stat_pr.htm.

Table 2.14 Selected Economic Indicators, India, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	7.4	6.5	7.6	6.0
Inflation	5.0	5.7	4.7	6.8
Current account/GDP	0.3	1.4	0.3	1.1

Source: Staff estimates.

have been relaxed, though banks' prime lending rates have seen only a small decline. Wholesale price inflation is picking up, mainly on the back of rising prices of petroleum, iron and steel, and coal. From an average of around 5.0% year on year in the first quarter (April–June) of FY2004, wholesale price inflation accelerated to 6.6% in July 2004, and further to around 8.0% in August 2004. As measured by the CPI for industrial workers, however, inflation remained moderate at 3.2% in the year to July 2004.

Full-year data now available for FY2003 indicate that the economy did well on the external front. Imports grew by 21.8%, reflecting strong domestic absorption, while exports expanded by 19.9% led by the growth of world demand, especially demand from the PRC and other Asian countries. Faster merchandise import than export growth swelled the trade deficit in FY2003, but despite this, the current account posted a higher surplus of 1.4% of GDP, up from 0.8% in FY2002. This was due to net invisible earnings of \$25.4 billion in the year, mostly from business processes sourced to India, including software and IT-enabled services. Services exports now account for over 30% of total exports and their share is rising rapidly. Exports of software and IT-enabled services alone had risen to \$12.2 billion in FY2003.

The capital account registered a significantly higher surplus in FY2003, of \$22.1 billion, split into net portfolio investments plus short-term loans of \$12.9 billion, net banking capital inflows of \$6.2 billion, and net other capital flows of \$3.0 billion. FDI was a very modest \$3.1 billion. With large surpluses on both the current and capital accounts, foreign exchange reserves increased by \$36.9 billion (including valuation gains) over the year to about \$113 billion by

31 March 2004, offering import cover of around 17 months. At that date, gross reserves were about equal to outstanding external debt.

External sector developments in the first quarter of FY2004 continued buoyant. Export growth surged to 28.0% from the year-earlier period, reflecting stronger global demand and manufacturers' responsiveness, while continuing firm domestic demand lifted imports by 31% in the period, including a 26% rise in non-oil imports. An overall surplus of \$7.5 billion was recorded in the quarter to bring foreign exchange reserves to about \$120 billion at end-June. Subsequently though, in July and August, momentum in the overall balance weakened as foreign exchange reserves declined by about \$2 billion (to \$117.5 billion at end-August 2004) in contrast to about a \$4 billion increase in these 2 months in the previous year.

The strong balance-of-payments position led to very easy conditions in the foreign exchange market in FY2003, and RBI intervened to release upward pressure on the local currency. Despite this intervention, the rupee appreciated by 9.3% against the dollar over the year to 31 March, or by about 5.9% using monthly average exchange rate data. In the following 5 months to end-August, despite net sales in the market by RBI since April, the rupee has tended to depreciate against the dollar with the August average rate about 3% weaker than in March. To accommodate foreign exchange market operations in FY2004, a Market Stabilization Scheme was established in April whereby the Government issues securities specifically for use by RBI to sterilize foreign exchange market intervention.

Policy Developments

The National Common Minimum Program (NCMP), announced by the new United Progressive Alliance Government that took office in May 2004, emphasizes economic reforms "with a human face." The main goals include generating employment and stimulating pro-poor growth, doubling rural credit in 2004–2007, increasing social spending, stepping up investment in the development and expansion of physical infrastructure, and eliminating the revenue deficit of the federal Government by 2009 to release more

resources for development spending (i.e., ending the crowding out). In order to tackle the problem of “jobless” growth, the NCMP also focuses on promoting employment-intensive growth.

The FY2004 federal budget released in July has attempted to translate some of these goals of the NCMP into concrete proposals. However, it has done so without much increase in total expenditures, which are projected to rise by only 0.73% in FY2004. This is partly because the federal Government did not pass on a large volume of funds raised from the states under the debt swap scheme, which has significantly compressed projected capital expenditures. On the other hand, total revenues are expected to grow by 17.6% from FY2003. Based on these estimates, the federal budget has projected a reduction of the revenue deficit from 3.6% of GDP in FY2003 to 2.5% of GDP in FY2004, and a reduction of the fiscal deficit from 4.8% to 4.4% in the same period.

Revenue proposals in the FY2004 budget included a surtax of 2% on all federal taxes and duties, to be earmarked for education. The service tax rate was raised from 8% to 10% and coverage was broadened from 58 to 70 activities. It also has a proposal to replace the long-term capital gains tax by a new transaction tax on market-traded securities (with a 0.15% rate), which will be shared equally by the buyer and the seller. To help prepare the textile sector for the removal of MFA quotas from the end of this year, various excise duty revisions have been introduced.

Apart from these tax measures and some other ad hoc revisions of rates of excise and customs duties, the budget has no major tax proposals. The finance minister has indicated that his tax reform proposals will be presented in the FY2005 budget (in February 2005) as part of his comprehensive medium-term fiscal consolidation program.

On the expenditure side of the FY2004 budget, the thrust is on education, especially primary education, and a proposed health insurance scheme for families below the poverty line. The budget also accords high priority to agriculture, rural infrastructure, and irrigation. It announced, in addition, an innovative program to restore about 500,000 out of 1 million traditional irrigation facilities that are cost effective to operate, while the coverage of the “last mile” irrigation

projects under the Accelerated Irrigation Benefit Program is also important. The emphasis on some specific antipoverty programs implies a new and sharpened focus on poverty reduction. The significant push to social and rural development programs notwithstanding, it is important to note there is no increase in such priority spending relative to GDP. Thus, total federal expenditures on education programs in the FY2004 budget at 0.4% of the GDP are exactly the same as in FY2003, as are federal expenditures on health programs at 0.25% of GDP. Similarly, federal spending on agriculture, rural development, irrigation, and flood control amounts to 2.18% of the GDP in FY2004 as compared with 2.19% in FY2003. This does not mean that increased spending on these programs is a myth: it simply points to the fiscal space expected from high growth.

However, a comprehensive fiscal consolidation program will be necessary, at least in the full-year budget for FY2005, to comply with the Fiscal Responsibility and Budget Management (FRBM) Act 2003, which requires a progressive reduction in both the revenue deficit and the fiscal deficit. The finance minister has announced that he will amend the Act to set FY2008 as the target date for eliminating the revenue deficit. He has also committed to prepare a medium-term fiscal consolidation program that will aim to reduce the fiscal deficit by 0.4 percentage points of GDP each year; to continuously monitor deficit performance; and to present quarterly performance reports to Parliament. A major initiative has already been taken in the direction of reform: the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act has submitted its report on consolidated fiscal reform, which is now being considered.

Apart from introducing tax and expenditure proposals, the federal budget is also a vehicle for announcing many policy proposals to indicate the broad direction of the Government’s overall economic management. Important among these are further liberalization of FDI ceilings, especially in telecommunications (from 49% to 74% of equity), civil aviation (from 40% to 49% of equity), and insurance (from 26% to 49% of equity). The Government is still deliberating its policy on disinvestments in public enterprises.

Meanwhile, it has proposed establishing a Board for Reconstruction of Public Sector Enterprises to recommend the sale or closure of unprofitable companies.

In the field of monetary policy, RBI has made no change to its key monetary targets in its Annual Policy Statement for FY2004, presented in May. In essence, the policy was to continue an accommodative stance on the assumption that underlying inflation did not worsen. More recently, in response to the unexpected acceleration in inflation, RBI tightened policy by raising the reserve requirement ratio to 4.75% from 18 September and to 5.0% from 2 October. These moves will likely result in higher interest rates and reduced bank lending. The Annual Policy Statement also dealt extensively with issues relating to the credit delivery mechanism, especially with regard to priority sector lending, micro-finance, SMEs, infrastructure, and the “gold card scheme” for exporters. In its recently submitted report, the Rakesh Mohan Committee on Administered Interest Rates proposed linking the administered rates on government securities with market interest rate movements, to ensure alignment of the two sets of rates.

The Government has also announced its new foreign trade policy for the next 5 years, which is aimed at doubling India’s share in world trade by FY2008. Currently, India accounts for only about 0.8% of global merchandise exports in contrast to its nearly 6% share in global GDP at purchasing power parity exchange rates or 1.6% share at market rates. Some of the highlights of the new trade policy include special initiatives for development of agribusiness and exports of traditional exports, such as handlooms, handicrafts, gems and jewelry, and leather and leather manufactures, through numerous tax incentives; further expansion of Agri Export Zones; and the establishment of “new towns of export excellence” as dynamic industrial clusters in selected sectors.

The policy has also laid down measures further simplifying the Government’s trade-processing procedures to reduce transaction costs and neutralize the incidence of duties on inputs used in export production through tax incentives. Moreover, the Government has announced various tax incentives for promoting infrastructure to facilitate exports. It is unclear whether the

proposed incentives are WTO compliant; they will also entail a significant revenue loss.

Outlook for FY2004–FY2005

The *ADO 2004* growth forecasts for FY2004–FY2005 have been revised down. This is partly on account of a weak monsoon, and especially because of the sharp increase in oil prices, which is both reactivating inflation and damping growth. A range of forecasts for FY2004 was prepared, and the best estimate of 6.5%, adopted for the *Update*, reflects 2.0% growth in agriculture and a weak monsoon, and 7.8% growth in both services and industry. In FY2005, GDP growth is expected to decline to 6.0%, despite the assumption of 3.1% growth in agriculture and a normal monsoon. This is mainly on account of lower projected growth in both industry and services as a consequence of the expected downturn in the country’s business cycle.

The risks associated with these growth projections include another weak monsoon in FY2005, higher than assumed global interest rates and crude oil prices, and inadequate progress in fiscal consolidation. Of all of these, the price of crude oil is the most critical for India, as it imports most of its oil. Past experience shows that a steep rise in oil prices triggers inflation, adversely impacts on the balance of trade, and lowers growth.

Rising inflation is likely to prevail through FY2004 and FY2005. Inflation is forecast at 5.7% and 6.8%, largely because of rising prices of oil and agricultural commodities in FY2004 and an expected escalation in the price of manufactured goods in FY2005. Manufacturers who are currently absorbing the increase in costs through reduced profit margins will eventually pass this on to consumers, leading to a lagged increase in industrial prices in FY2005 as a consequence of the oil price escalation in FY2004. The Government has taken some short-term measures to contain the impact on consumer prices, including a reduction in excise and customs duties on petroleum products, announced in August. For the long term, the Government is considering a strategic oil reserve in an attempt to moderate oil price volatility through buffer stock operations.

Though the fiscal deficit showed a slight

improvement in FY2003, it is likely to rise to 10.0% in FY2004. The federal budget has targeted a reduction in the FY2004 fiscal deficit to 4.4% in line with the FRBM Act. However, the target is likely to be overshoot because of ad hoc fiscal concessions being introduced after the budget to contain the inflationary impact of rising oil prices and because of the incentives introduced in the new trade policy. Moreover, the fiscal position of state governments further deteriorated through FY2003, and the reduction in federal revenues in FY2004 will also reduce their receipts from their share of federal revenues.

The fiscal situation of the federal Government, in contrast, is likely to recover in FY2005 because of the strong fiscal reform measures expected in that year's budget, and this will also have a positive impact through shared taxes on the revenue receipts of the states. This is likely to be reinforced by the states' fiscal consolidation proposals of the Twelfth Finance Commission, which will submit its recommendations in December 2004. Consequently, the consolidated fiscal deficit for FY2005 is projected to decline to 9.5% of GDP. Introduction of a VAT, which has been repeatedly postponed, has been tentatively rescheduled for 1 April 2005. However, even if it is introduced, its immediate impact on the fiscal deficit should be negligible as it has been designed to be revenue neutral.

Turning to the external sector, the outlook is buoyant. Based on expected strong global expansion, merchandise exports are projected to

grow by 20.9% in FY2004 and 17.9% in FY2005. India's export basket is quite diversified, ranging from traditional products, such as textiles and garments, to chemicals and pharmaceuticals, transport equipment, and other engineering products. The rise in exports is likely to be concentrated in textiles (following the elimination of MFA quotas at end-2004), and pharmaceuticals and automotive ancillaries (products for which exports have been rising rapidly). Imports are projected to grow at 19.9% and 19.3% in FY2004 and FY2005, respectively, based on the above domestic growth projection. The major components of India's merchandise imports are petroleum products, gems and semiprecious stones, chemicals including fertilizers, and machinery and electronic goods. The projected increases in imports will be dominated by the increase in the oil import bill.

With both merchandise exports and imports growing at similar high rates, the current account surplus is projected at 1.4% of GDP in FY2004, declining to 1.1% in FY2005 when merchandise imports are forecast to grow at a significantly higher rate than exports. Net invisibles income will continue to register robust growth. The overall annual net capital inflow of around \$22 billion is likely to increase further on account of the liberalization of FDI ceilings. Given that foreign exchange reserves will likely rise to over \$150 billion in FY2005, and the current account will remain in surplus, India's external position looks very comfortable over the medium term.