

India

Summary

In April, *ADO 2005* predicted that India's buoyant growth performance would continue in the medium term. It also identified several challenges, including meeting the fiscal consolidation targets as laid down in the Fiscal Responsibility and Budget Management Act of 2003, stepping up infrastructure investments, managing burgeoning foreign exchange reserves, and reinforcing India's competitive advantage in textiles and garments. This *Update* reconsiders prospects in a context where international oil prices continue to rise.

GDP grew by 6.9% in FY2004 (ended 31 March 2005), and it is expected that this momentum will be broadly maintained in FY2005–FY2006. The recent infrastructure initiative by the federal Government is expected to buoy activity, particularly in FY2006. High and rising oil prices have been factored into revisions of growth, inflation, and the current account.

The Mid-Term Appraisal of the 10th Five-Year Plan, published in June 2005, presents a detailed assessment of the performance of the economy as a whole as well as of individual sectors in relation to the 10th Plan targets. The picture that emerges is the following: the economy is doing well in several areas and gains in these areas need to be consolidated, but important weaknesses remain, which, if not corrected, could undermine current performance.

This *Update* highlights the constraints to growth posed by inadequate infrastructure. Federal and state governments have been unable to mobilize sufficient resources to support the outlays in line with the 10th Plan that are required to achieve its 8% annual growth target.

To close the gap over the medium term, both improved revenue mobilization and a rationalization of expenditure are needed.

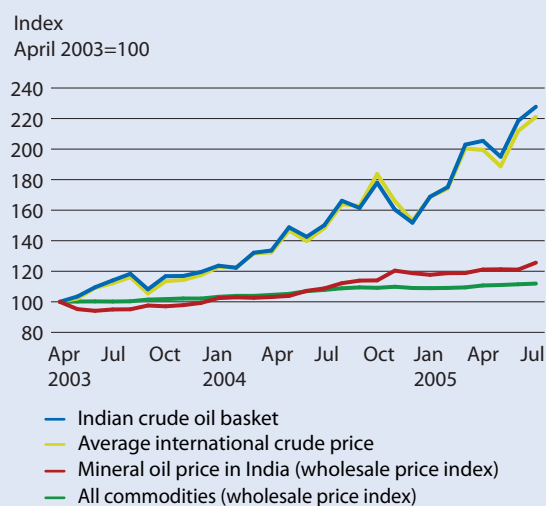
Updated assessment

Economic expansion in FY2005 is expected to maintain the pace of FY2004, and early data support this view. The Index of Industrial Production grew by 11.7% in June (year on year), a 9-year high, to record a 10.9% expansion in the first quarter of FY2005 (April–June 2005). Business confidence polls also generally report bullish expectations, although some surveys point to more tepid sales and output over the next 6 months.

The performance of the agriculture sector will be contingent on monsoon rains, as well as their geographic distribution. It is too early to accurately assess the final impact of the monsoon on agricultural activity, but there is some concern that it may be adversely affected by the uneven distribution of rain early in the season. Although agriculture remains important, accounting for about 25% of GDP and employing about 70% of the population, its share is declining and linkages between farm output and industrial activity are becoming weaker.

In view of developments in the early months, the GDP growth projection for FY2005 in *ADO 2005* of 6.9% is unchanged in this *Update*, and is based on the assumption of a normal monsoon. The Mid-Term Appraisal sees an average growth rate of somewhat more than 7% over FY2005 and FY2006.

Inflation, as measured by the wholesale price index, was 4.1% (year on year) as of 2 July 2005; excluding food the index was up by 4.7%. Prices

Figure 2.3 Oil prices, India, April 2003–July 2005

Note: The Indian crude oil basket is the weighted average of Oman-Dubai and Brent; the average international crude price is the unweighted average of Dubai, Brent, and West Texas Intermediate.

Sources: Datastream, downloaded 8 Aug 2005; Reserve Bank of India (RBI) Database on Indian Economy, available: <https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/>; RBI Macroeconomic and Monetary Developments, First Quarter Review 2005–06.

of some petroleum products (gasoline and diesel) were raised on 20 June 2005 and the oil products group subindex was up by 15.2% over the year. As indicated in Figure 2.3, wholesale prices of oil products have lagged markedly behind both the cost of the Indian crude oil basket and average international crude prices since April 2003. This divergence reflects underrecoveries of costs by the state-owned oil marketing companies and reductions in customs and excise duties. Financial pressures on these companies—which, largely because of underrecoveries, are incurring heavy losses—could well prompt further adjustment of product prices, affecting the outlook for inflation.

Full-year balance-of-payments data are now available for FY2004. Exports and imports grew by 25% and 48%, respectively, over the year. Oil imports cost \$30 billion, equivalent to 28% of total imports, and were up by 45% (or about \$9 billion) on the previous fiscal year, while non-oil imports rose even more rapidly. The current account surplus of \$10.6 billion in FY2003 slipped to a deficit of \$6.4 billion in FY2004, but strong capital inflows contributed to a healthy overall surplus of

\$26.2 billion. Foreign exchange reserves (excluding gold and special drawing rights) amounted to \$135.6 billion at end-March 2005, providing about 10.5 months of goods and services import cover. The rupee appreciated by about 2.2% against the US dollar over FY2004.

Customs data show that exports and imports grew by 19.5% and 38.0%, respectively, in the first quarter of FY2005, compared with the same period of the previous year. Oil imports rose by 33.2%. While export growth of textiles and readymade garments declined during January–March 2005, preliminary data for April 2005 revealed some turnaround in exports of cotton readymade garments. Although it is too early to tell what the impact of the removal of textile quotas might be, exports of textiles and garments to the US showed strong growth of about 35% over the first 5 months of 2005 from the prior-year period. Balance-of-payments data for the first quarter of FY2005 are not yet available, but data on official reserves show that, from the beginning of the fiscal year to 19 August, foreign exchange reserves rose by \$1.8 billion to \$137.4 billion.

In the first 2 months of FY2005, the gross fiscal deficit of the federal Government increased by 22% on the same period in FY2004. However, the Government is confident of keeping the deficit lower than the budgeted figure of 4.5% of GDP in FY2005. Collection of tax revenue has been very impressive so far this year, supported by buoyancy in industrial production and high growth of imports. As a result, the revenue deficit widened by only 0.8% during April–May 2005 on April–May 2004. However, both tax and nontax revenues may well come under some continued pressure in future months because of the losses of the state-owned oil marketing companies, which will affect any dividends they may pay to the budget as well as direct tax payments. Already, the first installment of advance tax payments from these companies is just 10% of the amount paid last year.

Value-added tax (VAT) is now being fully levied in 21 states, but serious fiscal challenges lie ahead. As states will no longer benefit from loan assistance from the federal Government for their development plans, they will have to take steps to improve resource mobilization and creditworthiness. Given their fragile fiscal situation,

Table 2.3 Selected economic indicators, India, 2005–2006, %

Item	2005		2006	
	<i>ADO 2005 Update</i>	<i>ADO 2005 Update</i>	<i>ADO 2005 Update</i>	<i>ADO 2005 Update</i>
GDP growth	6.9	6.9	6.1	6.8
Inflation (WPI)	4.2	4.8	3.0	3.3
Current account/GDP	-1.0	-1.5	-1.4	-1.8

WPI = wholesale price index.

Source: Staff estimates.

the states are finding it very difficult to mobilize resources for development expenditure, especially infrastructure investment.

Growth in money supply was 13.9% (year on year) as of end-June 2005 and within the indicative target (14.5%) of the central bank's annual policy statement. Bank credit to the commercial sector and net foreign exchange assets of the Reserve Bank of India were the major sources of money supply growth. Robust growth in nonfood credit is attributable to surging loans to housing and retail businesses, and healthy industrial activity. The growth in money supply would have been much higher over the year but for the efforts of the central bank to limit growth in reserve money by sterilized intervention through the Market Stabilization Scheme and the usual open-market operations. Through the first quarter of FY2005, liquidity remained comfortable in the system; interest rates were stable. No changes in policy rates were made at the Reserve Bank's first quarterly monetary policy review held on 26 July. Nevertheless, maintaining price stability in the context of rapid growth will continue to challenge the bank.

The primary equity markets remained quiet in the first quarter of FY2005. The secondary equity markets rallied strongly from June 2005 and both the BSE's Sensex and NSE's Nifty reached all-time highs and closed on 12 August at 7,767 and 2,361, respectively, up by 17.6% and 13.5% since 1 January 2005. This is partly attributed to the revival of investment by foreign institutional investors, which emerged as net buyers in June after being net sellers for 2 consecutive months. This recent trend may continue in the coming months as the Indian market has been favored by many international asset managers.

Prospects

In order to ease the infrastructure bottleneck, the prime minister approved the "Bharat Nirman" (Building India) program, which will entail an investment of over Rs1,740 billion (\$40 billion, equivalent to about 5% of FY2005 GDP) in six critical areas of rural infrastructure to be spent over a 4-year period starting in 2005. If implemented effectively and in a timely manner, this will help sustain high growth over the medium term. It will create additional demand for steel, cement, and other manufactured goods and, as a result, industrial growth in FY2006 is expected to be strong. Consequently, the *Update* projects GDP growth of 6.8% in FY2006, above the *ADO 2005* forecast.

The principal underlying forces in the outlook are the acceleration in private investment and the expansive outlook of the country's entrepreneurs; the rise of consumerism supported by a rapidly growing middle class; a more aggressive, competitive attitude by financial institutions, especially in housing and consumer lending but also in industrial and farm credit; the substantial business opportunities that success in export markets has shown to exist; and expansion of market liberalization policies by the Government.

Rising oil prices present a major source of uncertainty. India is heavily reliant on oil imports and is comparatively energy inefficient. Healthy foreign exchange reserves mean that higher import bills can be accommodated, but the effects of increased costs on producers and consumers are more difficult to predict. The underrecoveries of costs (i.e., losses), which are currently being borne by the oil marketing companies, are beginning to surface in cash-flow management problems.

Estimates of the implications of higher oil prices for the economy suggest that if prices are at about \$70 per barrel through end-2006, growth could be clipped by up to 1.1 percentage points—assuming of course that other things are equal. But other things are not equal, and this negative impact is expected to be offset by other positive effects, including the Government's initiatives on infrastructure investment. The outlook for high global oil prices, however, has required revisions

to the forecasts for inflation, imports, and the current account.

Although an April 2002 reform in principle stipulated that most petroleum product prices should be adjusted every 2 weeks to import parity levels at ex-refinery and retail levels, in practice few retail price adjustments have been made in FY2004 or to date in FY2005. As a consequence, underrecoveries by state-owned marketing companies mounted rapidly to Rs199.1 billion (\$4.4 billion) in FY2004 or 0.6% of GDP. These underrecoveries are in addition to budget subsidies of Rs36 billion (\$0.8 billion) for kerosene and liquefied petroleum gas for poor consumers paid by the budget and a Rs32.6 billion (\$0.7 billion) contribution made by upstream oil companies. For the first quarter of FY2005, underrecoveries were reported to be Rs97 billion (\$2.3 billion) and, on the current trend, will reach about 1.1% of GDP for the year (again, this would be in addition to Rs36 billion of subsidies in the FY2005 budget and any upstream contribution). Although further price adjustments would bring down this estimate, substantial adjustments would add to prospective price pressures.

To limit underrecoveries by the oil marketing companies, the Government reduced customs and excise taxes on oil and petroleum products in FY2004. Subsequently, the budget for FY2005 called for further adjustments: cutting the customs duty on crude oil from 10% to 5% while the structure of basic excise duty on petroleum products was changed with a major reduction in rates. These changes to taxes, in addition to the earlier cuts in excise taxes, will have a perceptible impact on prospective tax revenues in FY2005 and beyond, apart from loss of any dividends that the companies might pay to the budget. Since customs and excise taxes on oil have accounted for about 20% of the federal Government's gross tax revenues in recent years, the adjustments are

not insignificant, especially in light of objectives to reduce the budget deficit.

It is difficult to predict the exact timing and extent of any petroleum price adjustment as it would be sensitive to general economic conditions and political circumstances. Such an adjustment would also have to be made in conjunction with monetary policies designed to keep inflation (and its expectations) anchored. In view of this, average wholesale price inflation for FY2005 is now forecast at 4.8% as against 4.2% predicted in *ADO 2005*, while the FY2006 projection is raised by 0.3 percentage point to 3.3%.

Forecasts for imports and the current account deficit have also been revised to account for higher international oil prices now specified in the *Update* baseline assumptions. Imports are projected to grow by 24.4% and 21.6% in FY2005 and FY2006, respectively. Accordingly, the current account deficit is raised to 1.5% of GDP in FY2005 and 1.8% in FY2006, about one half percentage point above the *ADO 2005* forecasts.

Regarding exports, it is expected that growth of 14% could easily be achieved despite possible slower growth in the world economy than was seen in FY2004. Moreover, a change in direction of exports toward rapidly growing East Asian economies provides a cushion for Indian exports, given the slowing in export demand emanating from its traditionally largest trading partners—the US and European Union. A structural change has been taking place in India's export basket in recent years: services, especially financial services and information technology-enabled services, have emerged as a very important export component. Exports of these services appear to be comparatively less affected by the volatility of world GDP growth. Despite the expected widening of the current account deficit, continued strong capital inflows are expected to keep the overall balance in surplus.