

# India

Strong agricultural results and a steady expansion of industry and services fueled 8.4% GDP growth in FY2005 (April 2005–March 2006). Key developments over the first 5 months of FY2006 include: steadily accelerating industrial expansion; further delays in adjusting domestic fuel prices as international oil prices rise; deterioration of the federal Government’s fiscal position; and rising inflationary pressures from food and fuel prices, as surging demand for credit has both led to higher interest rates and complicated attempts to control the money supply. Relative to the forecast given in *Asian Development Outlook 2006 (ADO 2006)* in April this year, growth of 7.8% is now expected in FY2006 and FY2007 (a marginal increase for FY2006), and the inflationary outlook is more uncertain. A smaller current account deficit is now forecast in light of stronger than expected industrial exports.

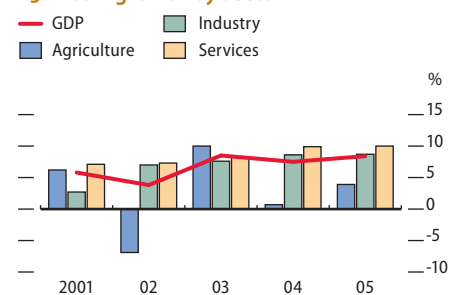
## Updated assessment

While India’s rapid and stable expansion in services has been widely recognized (services contributed 54% of GDP and 63% of growth in FY2005), revised national income data for the year confirm a steadily accelerating industry sector (Figure 2.3.1). Industrial growth of 8.7% complemented a 10% expansion in services and a good year for agriculture (which grew by 3.9%, up from 0.7% in FY2004). Full-year balance-of-payments data for FY2005 show a 27.5% rise in merchandise exports (measured in nominal US dollars), comprising primarily industrial products—transport equipment; machinery; readymade garments; basic chemicals and pharmaceuticals; woolen yarn; and fabrics.

FY2005 marked the fourth successive year that manufacturing has led merchandise export growth in excess of 20%, confirming that Indian manufacturers are carving out important, high-growth international markets for themselves. Continuing this trend, manufacturing in the first quarter of FY2006 was up by 11.2% on the same period of the previous year, with capital goods production rising by 22.9%. Further buttressing the outlook for investment and industrial expansion, the Directorate General of Commercial Intelligence and Statistics reports that exports in the first quarter of FY2006 were up by 16.9% year on year.

Moderating these buoyant prospects for FY2006 slightly, the Business Confidence Index of the National Council of Applied Economic Research for July–December 2006 shows that, while firms remain upbeat about production growth and exports, they are nervous about slowing profit growth and the rising cost of capital. To illustrate, in FY2005, the net profits of a sample of 1,450 manufacturing companies cited in

2.3.1 GDP growth by sector



Source: Central Statistical Organization, available: <http://mospi.nic.in/cso.htm>, downloaded 3 June 2006.

the monthly review of the Economic and Political Weekly Research Foundation recorded their lowest rate of increase in the last 4 years. Rising bank lending rates compounded the pressure on profits, and continue to do so.

Outstripping export growth, merchandise imports grew by 31.6% in FY2005, with imports of crude oil and oil products surging by 47.3% in value terms. The oil import bill in the first quarter of FY2006 was 39% higher than in the same quarter of FY2005, due almost entirely to price increases. Yet despite higher international oil prices, the current account gap in FY2005 was held in check by the stellar performance of exports, and widened only to 1.3% of GDP, from 0.8% in FY2004.

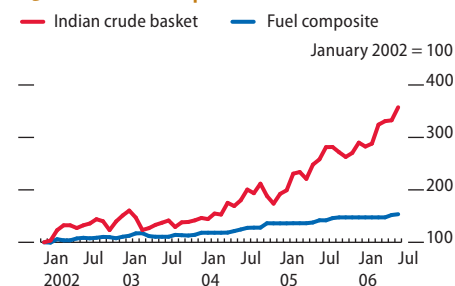
Rising international oil prices pose significant fiscal and inflationary risks, as domestic fuel prices have been allowed to climb only much more slowly (Figure 2.3.2). The federal Government revised marginally the (administered) prices of gasoline and diesel by 9% and 6%, respectively, in the first week of June—the first revision since August 2005—and lowered duties on gasoline and diesel. Notwithstanding the February recommendations of the Government’s Committee on Pricing and Taxation of Petroleum Products, the domestic price of cooking gas was left untouched.

By 14 July 2006, the wholesale price index (WPI) for fuel had risen by 52% since the beginning of 2002, while the crude-oil basket had risen by 333% to \$73.96 per barrel over the same period. Thus, the implicit quasi-fiscal burden of fuel price controls continues to expand. Although the public oil-marketing companies (whose total underrecoveries in FY2006 were projected at roughly \$15.9 billion in June, or roughly 2% of GDP) were recently given permission to revise retail fuel prices if the monthly average price of India’s crude-oil basket crossed \$70 per barrel, implementation remains uncertain for political reasons. These delays in adjusting fuel prices risk heightened inflationary expectations.

Inflation, as measured by the WPI, began rising in May 2006, touching 5.4% by the third week of June (Figure 2.3.3). The upward trend has been led by rapidly growing prices of “primary articles” (with a 22% weight in the WPI), especially vegetables, pulses, and wheat. “Other commodity” price inflation (with a 14.2% weight) is also a factor, having risen on higher international oil and other commodity prices, the June retail fuel price adjustment, and rupee depreciation. Manufactured goods inflation (63.8% weight), despite picking up slightly, remains restrained.

Food price rises do not stem from low production: harvests in FY2005 were good. Rather, they can be linked to liberalization of rules on the activities of private stockholders, traders, and agroprocessors in, perhaps, three ways. First, some observers argue that liberalization has permitted various private traders to corner markets, though this argument is difficult to verify. Second, other commentators cite inefficient federal buffer stock management in the context of liberalization, which allowed federal wheat stocks to fall to roughly 10% of their historical norm by April 2006, sharply constraining the Government’s usual price-smoothing operations. Low stocks stem both from several poor harvests prior to FY2005, and from the fact that the minimum support prices offered to farmers have lately been far below market prices (for example, only Rs7.0

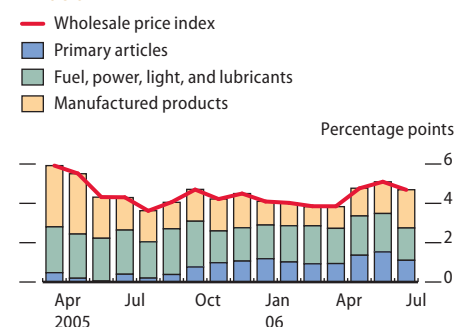
### 2.3.2 Oil and fuel price indexes



Note: The Indian crude basket has been converted to rupees prior to indexing. The fuel composite is the weighted average of the WPI for gasoline, high-speed diesel oil, LPG, and kerosene.

Sources: Datastream; CEIC Data Company Ltd., downloaded 3 August 2006.

### 2.3.3 Contributions to wholesale price inflation



Source: Reserve Bank of India, Database on Indian Economy, available: <https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/>, downloaded 16 August 2006.

per kilogram in May 2006 for wheat, compared with Rs13.7 in the Delhi wholesale market). Third, liberalization of agroprocessing has released pent-up demand for food inputs for processing, pushing up prices.

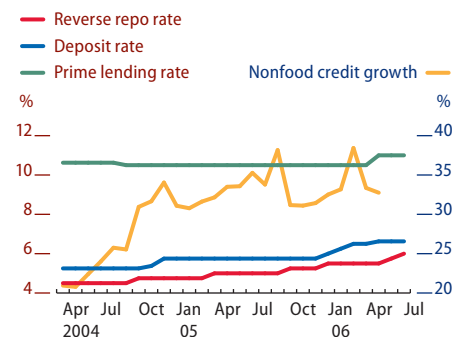
In response to such burgeoning price pressures, the Government has temporarily reduced import duties on food, and has resolved to use the futures market more effectively for stock smoothing. The latter is a critical, if belated, component of a sensible liberalization plan, as it permits the Government to maintain a public claim on a substantial buffer stock (thus smoothing prices and discouraging would-be market manipulators), while allowing private traders and agroprocessors to manage stocks for their own use.

In an effort to curb inflationary expectations and to siphon off excess liquidity, the Reserve Bank of India (RBI) raised its key short-term—repo and reverse repo—interest rates by 25 basis points in early June 2006 and again in late July (Figure 2.3.4). Notwithstanding earlier tightening, money supply growth, at 18.8%, continued to outstrip the RBI's 15% target by the first week of July, mainly because of growth in bank credit. Robust demand for credit and a shift in household savings toward mutual and pension funds have placed upward pressure on bank deposit rates, and consequently, on lending rates. Concerns have arisen that short-term policy interest rate hikes may not suffice to contain credit-driven expansion in the money supply. Yet firms are wary of rising capital costs, and the RBI appears attuned to the fact that inflationary pressures are coming from aggregate supply as well as aggregate demand, implying that monetary policies need to be supplemented with structural responses in the areas of food and fuel.

Against this background of socially sensitive food and fuel price pressures, the federal Government is struggling to balance fiscal prudence with provision of resources for development expenditure. The federal gross fiscal deficit for the first quarter of FY2006 totaled a worrying 52% of the targeted deficit for the entire year. This high rate is primarily attributable to a sharp rise in spending on the National Rural Employment Guarantee scheme, which has lately been implemented in some additional states. Moreover, the Government's disinvestment program was recently suspended following a political crisis that broke out over the proposed privatization of a publicly owned lignite mining company in Tamil Nadu. While tax revenues have been very impressive so far, supported by buoyant industrial production, they are likely to come under some pressure in the future owing to the lowering of customs duties on key primary articles (mainly food), gasoline, and diesel. Continuing losses at the oil-marketing companies will also hamper tax and dividend federal revenues. Thus, meeting the federal Government's deficit target of 3.8% of GDP has emerged as a major challenge.

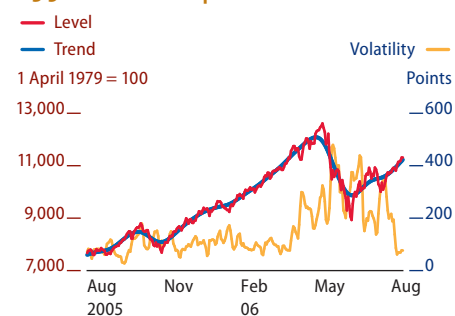
The Bombay Stock Exchange Sensitivity Index (BSE Sensex), which more than tripled over 3 years, experienced a sharp increase in inter- and intraday volatility from the first week of April 2006 (Figure 2.3.5). After touching an all-time high of 12,600 in early May 2006, the Sensex dropped rapidly, coincident with a temporary reversal of inflows from foreign institutional investors (FIIs) (Figure 2.3.6) similar to those into other emerging markets, and a resumption of rupee depreciation (3.5%

### 2.3.4 Interest rates and nonfood credit growth



Source: CEIC Data Company Ltd., downloaded 16 August 2006.

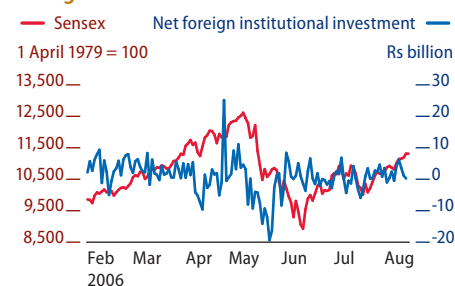
### 2.3.5 Sensex stock price index



Note: Trend line is calculated using a Hodrick-Prescott filter (with a penalty on variation of 1,600). Volatility is measured as a 10-day standard deviation of Hodrick-Prescott residuals.

Source: Datastream, downloaded 16 August 2006.

### 2.3.6 Sensex movements and net foreign institutional investment



Sources: Datastream; Securities and Exchange Board of India, available: <http://www.sebi.gov.in>, downloaded 16 August 2006.

against the US dollar between 3 April 2006 and 6 July 2006—Figure 2.3.7). Given the small share of FII activity in the total turnover on India's equity market (8.1% in FY2005 according to the Government's *Economic Survey*), and some econometric evidence that FII behavior responds to local equity prices rather than the other way round, much of the momentum behind the adjustment must have been local. Indeed, local investors appear to have retreated from stocks to safer assets as the adjustment progressed.

Since early July, the Sensex has resumed an upward trend, and inflows from FIIs have returned to positive territory, suggesting some earlier overshooting—a view corroborated by business confidence indicators. Notwithstanding the current account deficit, a steady increase in foreign direct investment and net-positive inflows from FIIs, especially to manufacturing, business, and computer services, permitted a foreign exchange accrual of \$15 billion in FY2005 (Figure 2.3.8), raising foreign exchange reserves by \$10.1 billion (net of valuation change) to \$145 billion. Foreign exchange reserves increased further by \$13.4 billion in the first 4 months of FY2006. Despite these inflows and industrial export growth, the rupee remains under pressure as international oil prices firm.

## Prospects

Three of the four assumptions specific to India underlying the *ADO 2006* forecasts are maintained: gradual monetary tightening will continue through 2006; southwest monsoon conditions will be roughly average; and attempts to improve urban planning and expand infrastructure will continue. However, the fourth assumption—that the recommendations of a national committee on the pass-through of international oil and gas price increases to local fuel prices would be implemented by mid-2007—requires modification.

On the one hand, the growing losses of the oil-marketing companies imply both cash-flow problems that limit much-needed investment by these companies, and, ultimately, substantial fiscal pressure that portends further domestic fuel price increases. On the other, the general rancor that greeted the June fuel price hike, coupled with higher food price inflation and the restraints on the coalition Government, makes further large imminent price rises extremely unlikely. Therefore, while this forecast assumes further gasoline and diesel price increases later this fiscal year, rationalization with international prices by mid-2007 is unlikely. Similarly, the targeting of subsidies on liquefied petroleum gas and kerosene is unlikely to be tightened to exclude the nonpoor until later in the year, if at all.

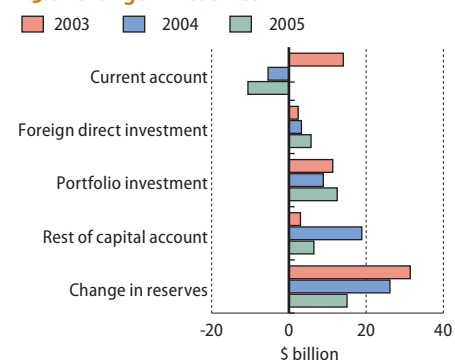
Developments in FY2006 dictate only slight revisions to the growth forecast for FY2006, and none for FY2007. The hardening of interest rates (which was anticipated) is unlikely to significantly dampen domestic demand growth this fiscal year. On the demand side, still-strong business confidence, accelerating industrial production, widespread capacity constraints, and robust expansion of capital goods production imply that investment is unlikely to decelerate before FY2007 begins, even if infrastructure bottlenecks become tighter. Despite recent growth, consumer finance is not widespread (loans to consumers for housing

2.3.7 Nominal exchange rate



Source: Reserve Bank of India, Database on Indian Economy, available: <https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/>, downloaded 16 August 2006.

2.3.8 Change in reserves



Source: Reserve Bank of India, Database on Indian Economy, available: <https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/>, downloaded 1 August 2006.

and consumer durables accounted for only 8.6% of total bank credit in FY2004), so that changes in interest rates will have only minor effects on household spending. Conversely, delays in fuel price adjustments imply that nonfuel consumption may be slightly higher than was anticipated in *ADO 2006*, boosting real expenditures. The improved outlook for exports is slightly overshadowed by expected import growth.

Turning to the supply side, industrial expansion is expected to accelerate to around 9% in FY2006, almost catching up that of services. These trends point to an overall growth rate of 7.8% in FY2006 (Figure 2.3.9). The forecast for FY2007 remains unchanged, also at 7.8%, reflecting firming growth in industry and a maturing high-end services sector.

Sustaining the high industrial growth rates required to realize the FY2007 growth forecast (much less the 12% average industrial growth target of the recently released Approach Paper for the 11th Five-Year Plan: FY2007–FY2011) will require more and better infrastructure and continued high levels of investment.

Given both limited progress in attracting private infrastructure investment, as well as the improvements in governance, bureaucratic processes, and dispute-resolution mechanisms required to ensure an adequate investment environment, the Government has announced an ambitious plan for developing special economic zones (SEZs). It has approved private investments of a trillion rupees in SEZs over the next 3 years, which it estimates would boost employment opportunities significantly (though not all these jobs will be new, since some of them will reflect economic activity diverted to these enclaves). In addition to permitting captive infrastructure facilities, which should be easier to manage on a commercial basis than the nation's wider infrastructure, the SEZ Act of 2005 provides several incentives to participating firms, including exemption from customs duty, excise duty, etc; 100% income tax exemption for 5 years; and dedicated courts and administrative authorities for each SEZ. There is active debate on the fiscal cost of these incentives, which, in combination with other fiscal pressures, clouds the FY2007 outlook.

Some recent developments are contributing to inflationary pressures, while others are alleviating them. Recent inflation in essential food items is stoking inflationary expectations, as well as contributing to the actual FY2006 average inflation rate. However, changes in the way that government food security agencies use futures markets, the reduction in food import tariffs, and the normal monsoon forecast suggest that this food price spike may be short-lived, ameliorating inflationary pressures in both FY2006 and FY2007. Rising prices of fuel imports are certainly adding to inflationary concerns, even while the delays in pass-through mean that their direct impact on current prices will be limited.

Consequently, the baseline WPI inflation forecast remains unchanged from *ADO 2006* at 5.5% for FY2006 and 5.0% for FY2007 (Figure 2.3.10). However, inflationary risks are building: no experience exists to evaluate the likely efficacy of remedial actions on food prices in the newly liberalized environment; the fuel price problem is unlikely to be resolved soon; and while the RBI will probably need to take stronger measures to restrain liquidity, it remains wary of the real-economy consequences of

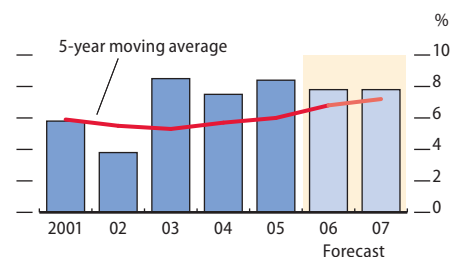
### 2.3.1 Selected economic indicators, %

	2006		2007	
	<i>ADO 2006</i>	<i>Update</i>	<i>ADO 2006</i>	<i>Update</i>
GDP growth	7.6	7.8	7.8	7.8
Inflation <sup>a</sup>	5.5	5.5	5.0	5.0
Current acct. bal. (share of GDP)	-3.0	-2.1	-3.3	-1.9

<sup>a</sup> Wholesale price basis.

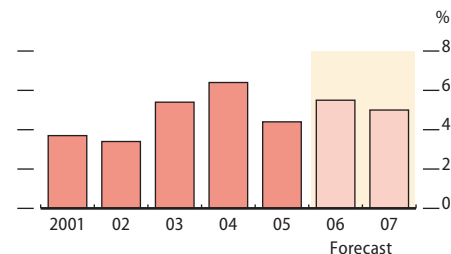
Source: Staff estimates.

### 2.3.9 GDP growth



Sources: Central Statistical Organization, available: <http://mospi.nic.in/cso.htm>, downloaded 3 June 2006; staff estimates.

### 2.3.10 Annual inflation



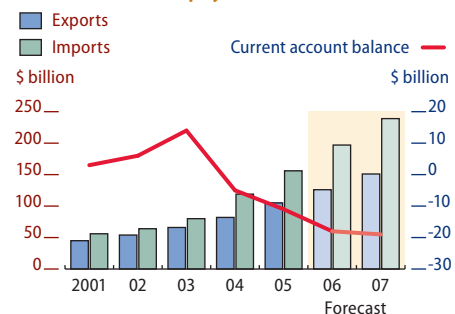
Sources: Reserve Bank of India, Database on Indian Economy, available: <https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/>, downloaded 31 July 2006; staff estimates.

doing so. Confirming these gathering risks, the RBI has signaled that, if necessary, it will not hesitate to squeeze liquidity further, perhaps by varying the medium-term interest rate (the RBI bank rate), which it has left untouched since April 2003, or even by raising the cash-reserve ratio.

As mentioned, the FY2005 current account deficit came in substantially lower than was expected when *ADO 2006* was produced. The acceleration of exports, particularly manufactures, appears to reflect a strengthening industrial export position across the board, and might well be sustained through FY2006. Thus, the current account forecast needs to be adjusted positively. However, relative to *ADO 2006*, this *Update* revises assumptions regarding international fuel and nonfuel commodity prices upward, while the Government has not strengthened price signals to curb domestic energy consumption to the extent earlier assumed. In light of these developments, the current account forecast for FY2006 is adjusted to reflect a deficit of \$18.4 billion (Figure 2.3.11), or 2.1% of GDP, down from *ADO 2006's* 3.0% deficit. Similarly, a current account deficit of \$19.0 billion, or 1.9%, is forecast for FY2007 (against 3.3% previously), as rising domestic fuel prices and stabilizing international oil prices constrain growth in the oil import bill.

The key risks to the above outlook stem from the hardening of interest rates, incomplete oil price pass-through, and the deteriorating fiscal position. The first of these three factors could eventually deter private investment; the second has inflationary and fiscal implications; and the third could severely limit the Government's ability to loosen critical infrastructure bottlenecks, thereby restraining much-needed investment. Because resolution of the fuel price problem has in effect been postponed, and the risks to investment would still be nascent this fiscal year, each of these risks factors, if realized, would adversely affect growth, inflation, and the fiscal position in FY2007.

### 2.3.11 Balance-of-payments indicators



Sources: Reserve Bank of India Bulletin, June 2006, available: <http://www.rbi.org.in>, downloaded 31 July 2006; staff estimates.