



India

In 1995, India was able to sustain a high rate of economic growth as reforms initiated in the wake of the macroeconomic crisis of 1991 took stronger hold and the economic recovery gained further momentum. Reflecting the liberalization of the trade and external payments regimes, increased integration of India into the global economy, and strong pent-up domestic demand, imports rose at a faster pace than did exports. As a result, the deficit in the external current account widened during 1995. Owing mainly to the moderation in capital inflows and bunching of debt-service payments, gross international reserves declined and pressure on the exchange rate emerged.

The Government continued its reform efforts in 1995, albeit at a more moderate pace. Initial measures aimed at improving the efficiency of resource allocation and expanding the productive capacity of the economy were followed by reforms of the financial and capital markets. However, in consolidating its program of structural adjustment, the Government is faced with a number of difficult issues. The fiscal deficit, although lowered over the past two years, is still too high and needs to be reduced further. The country's infrastructure needs to be modernized and expanded; however, to do so will place heavy pressure on public finances unless an attractive climate for private investment in this area can be established. Inadequate progress has so far been made in public sector and labor market reforms, while poverty alleviation and human resource development remain important tasks. There are also institutional

constraints arising from the limited progress of reforms at the state government level. These problems need to be addressed with some resolve if the Indian economy is to sustain a high rate of growth over the long run.

Recent Trends and Prospects

Growth, Investment, and Employment. Reflecting a broad-based economic recovery, real GDP is estimated to have increased by 6.2 percent in 1995, virtually the same as in 1994 and significantly better than the growth rate of 5 percent recorded in 1993. Agricultural output, however, was only 0.5 percent higher than in 1994, partly because of adverse weather conditions, but also because sectoral growth in 1994 had been exceptionally high at nearly 5 percent. Foodgrain production in that year reached a record level of 191 million tons, with wheat output increasing by nearly 10 percent and pulses by 6 percent. There were also large increases in the output of sugarcane, and jute and cotton production recovered well from the decline in output experienced in 1993. For the most part, the levels of production reached in 1994 were closely matched in 1995. Although its share of GDP continues to decline as industrialization proceeds, agriculture still accounts for about 28 percent of GDP.

The industry sector, however, continued to be the main driving force behind the high growth rate of the economy over the past two years, supported by a solid performance from the services sector which grew by 6.1 percent

Table 2.15 Major Economic Indicators: India

		1993	1994	1995	1996	1997
Gross Domestic Product ^a	% change	5.0	6.3	6.2	6.4	6.6
Agriculture	% change	3.3	4.9	0.5	3.0	3.8
Industry	% change	4.2	8.3	12.0	9.4	8.6
Services	% change	6.8	6.0	6.1	6.4	7.0
Gross Domestic Investment	% of GDP	21.6	25.2	24.0	24.5	25.0
Gross Domestic Saving	% of GDP	21.4	24.4	22.5	22.5	23.0
Inflation Rate	% change in CPI	7.5	10.1	9.5	9.0	8.0
Money Supply Growth	% change	18.4	21.2	15.6	15.0	15.0
Merchandise Exports	\$ billion	22.7	26.8	32.4	38.2	43.9
	% change	20.3	17.9	21.1	18.0	15.0
Merchandise Imports	\$ billion	24.0	31.3	39.6	47.9	56.5
	% change	3.2	30.4	26.7	21.0	18.0
Current Account Balance	\$ billion	-0.3	-2.3	-5.1	-6.3	-8.0
	% of GDP	-0.1	-0.8	-1.6	-1.7	-2.0
External Debt Outstanding	\$ billion	92.1	99.0	104.3	114.0	125.7
Debt-Service Ratio	% of exports	26.1	26.3	26.7	26.8	27.6

^a Based on constant 1980 factor cost.

Note: All data are on fiscal year basis. Data on inflation may differ from the series contained in the Statistical Appendix (see Statistical Notes).

Sources: Government of India, Ministry of Finance, *Economic Survey 1995-96* (New Delhi, 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

in 1995 as in 1994. Industrial production, which accounts for about 31 percent of GDP, increased by 12 percent in 1995. This was largely because of strong manufacturing growth, which was widely spread among industries. A number of industries, including food products, wood and wood products, paper, non-metallic mineral products, basic metals, machinery, and transport equipment, grew at 12–15 percent or more. Others, particularly traditional industries such as cotton textiles and yarn, did not fare as well, and had much lower growth rates. The vigor of growth now being displayed by the industry sector in India is related to the various policy initiatives affecting the sector taken by the Government since 1991. These include the deregulation and delicensing of industries, the rationalization and reduction of import tariffs, the removal of import licensing, and the reduction of corporate taxes.

Available data give an unclear picture of the course of investment and saving since the reform process began in 1991. Although gross domestic investment in 1995 declined

to an estimated 24 percent of GDP from 25.2 percent in 1994, it was still higher than in the early years of the reform period from 1991 to 1993. Also, in recent years, the share of the private sector in gross fixed capital formation has risen, indicating a positive response from the private sector to the deregulation of the economy. Gross domestic saving also declined for a few years following liberalization, especially in the household sector, and at 22.5 percent of GDP in 1995 was still below the level of 1991. However, saving in the private corporate sector during the past two years has been above that in 1991. The resource gap in 1995 is estimated at 1.5 percent of GDP compared with 0.8 percent in 1994 and 0.6 percent in 1991, and was reflected in a widening of the current account deficit and hence increased reliance on foreign savings.

Data on the current state of employment and labor market conditions in India are relatively sparse. There are, however, indications that the annual increase in employment rose from some 3 million in 1991 to more than 7 million in 1994, augmenting the

labor force by more than 20 million to over 320 million during that period. In 1995, it is estimated that the increase in employment was similar to that in 1994. The informal sector continues to account for the dominant share of total employment (about 90 percent), and has experienced relatively higher growth compared to that of the formal sector in most economic activity, particularly in manufacturing, construction, and transport. Since labor is the principal asset possessed by the poorer strata of society, improvement in employment opportunities is likely to have been associated with favorable trends in living standards and poverty. The introduction of various relief employment programs, the strengthening of the public distribution system for food, and other related measures have also played an important role in assisting the poor.

Given normal weather conditions, GDP growth is expected to increase to 6.4 percent in 1996 and 6.6 percent in 1997. Agricultural output should expand more strongly than in 1995 at 3 percent in 1996 and further to 3.8 percent in 1997. The industry sector is expected to show the fastest growth rates at 9.4 percent and 8.6 percent in 1996 and 1997, respectively. The services sector, which accounts for about 41 percent of GDP, is expected to improve its growth rate to 6.4 percent in 1996 and 7 percent in 1997, with continued strong growth in external trade and financial sector reforms being beneficial influences.

Investment is projected to increase slightly by 0.5 percentage points relative to GDP in each of the next two years, mainly because of higher private investment, although some rise in public investment late in the period would reinforce this trend. The rate of saving is forecast at 22.8 percent of GDP over the next two years and, in consequence, the resource gap will widen slightly. The maintenance of strong economic growth in 1996 and 1997, especially the recovery in agricultural output, should enable employment opportunities to be created at much the same rate as in 1995. Increased spending on various rural employment programs introduced in recent years will help to achieve that result.

Budget, Money, and Prices. Considerable progress in the reduction of the Central Government's fiscal deficit was achieved in 1995. The budget for 1995 provided for a deficit of 5.5 percent of GDP; the deficit

was, in fact, 5.3 percent, about one percentage point lower than the 6.5 percent recorded in 1994, and well below that of 1993 when the deficit had moved sharply upwards to 7.5 percent of GDP (Figure 2.19). Even though total revenue exceeded budget estimates, the excess was insufficient to cover over-budget expenditure, especially on subsidies, social services, and loans to the state governments.

Total revenue receipts in 1995 were 21 percent greater than in 1994, rising to 10.1 percent of GDP from 9.6 percent. Tax revenue was up by over 20 percent, reflecting not only the strength of economic growth but also tax reforms introduced in the 1995 budget and previously to widen the tax base, improve tax administration and compliance, and increase buoyancy of the tax system. Capital receipts (excluding borrowing), however, declined by some 26 percent, principally because expected divestment of equity in state-owned enterprises failed to occur.

Total expenditure in 1995 was nearly 14 percent greater than in 1994; however, in GDP terms, it declined fractionally from slightly above 17 percent to 16.8 percent. Nearly all of the increase was accounted for by current expenditure, which rose by 17.5 percent against an increase of only 2.2 percent in capital outlays. Apart from higher recurrent expenditure on socioeconomic services and other items, a major expense in 1995 was a rise of around 18 percent in debt interest payments, which now account for about 30 percent of total expenditure or about 4.8 percent of GDP.

The state governments have so far made relatively little progress in fiscal adjustments to bring their expenditure in line with available revenue, although they have recently initiated some reforms and are considering modifications to their tax systems and improvements in expenditure management. However, unless these reforms are implemented expeditiously and include both revenue-enhancing and expenditure-reducing measures, there is a risk that fiscal adjustments by the Central Government could be undermined by expansionary policies on the part of the states. The fundamental weakness of the states' finances continues to be reflected in the persistence of revenue deficits, large borrowing requirements, and a declining share of investment outlays in total expenditure. The states' fiscal deficit increased from 3.1 percent of GDP in 1993 to

3.6 percent in 1994 and is estimated to have remained at about that level in 1995.

The weak financial performance of public enterprises continues to put pressure on public finances. In many sectors, such as textiles, steel, and fertilizers, the profit margin of these enterprises is negative. The largest drain on public finances is due to the State Electricity Boards which absorb a significant fraction of plan outlays but report heavy losses resulting mainly from transmission and distribution losses and from subsidization of the power tariff for the agriculture sector. Restructuring of these enterprises should focus on increasing their managerial and financial autonomy, improving their physical performance, and making them more commercially viable.

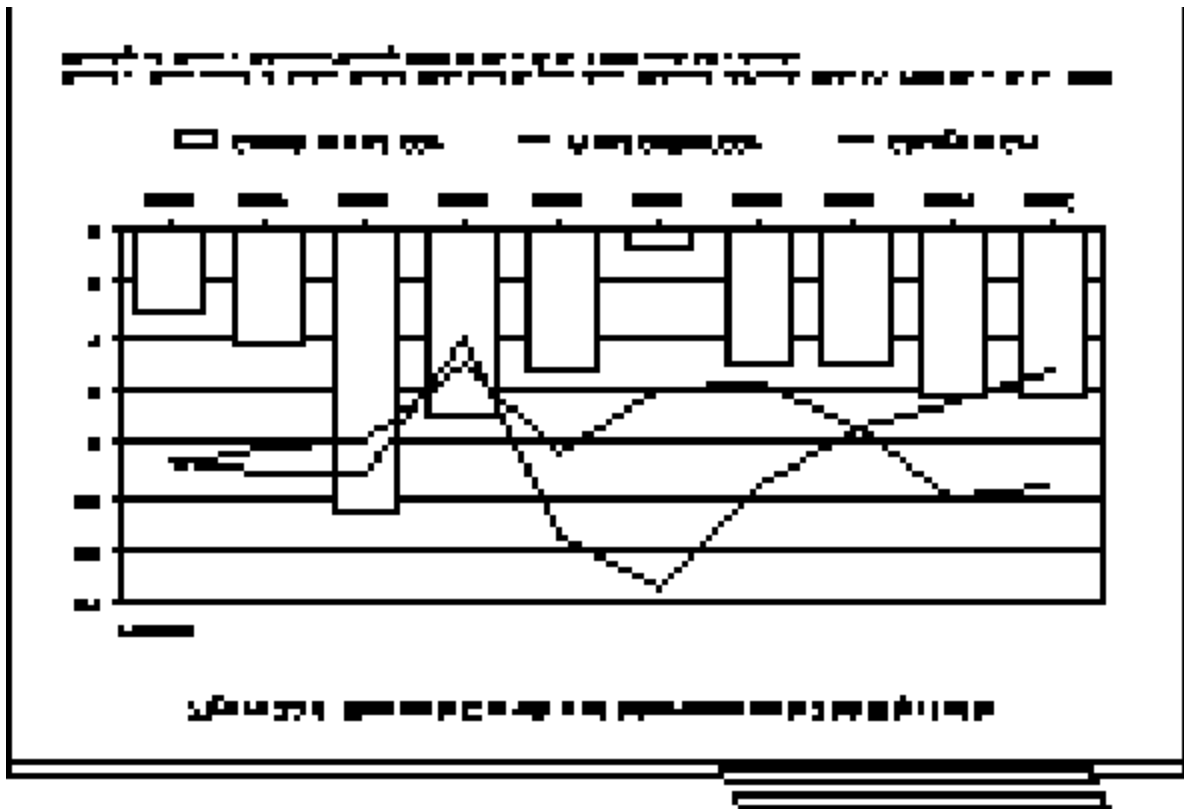
Unlike in 1994, when monetary expansion was mainly due to a surge in capital inflows, growth in the monetary base during the year resulted essentially from recourse to Central Bank credit by the Central Government. To some extent, however, this also reflected a more moderate increase in the placement of government securities with the banking system, effectively constraining the Government's ability to raise finances from this source. For the year as a whole, growth in monetary expansion moderated somewhat. Reflecting lower capital inflows and the absence of large-scale foreign exchange purchases by the Central Bank, broad money is estimated to have increased by 15.6 percent in 1995 compared with 21.2 percent in 1994. With credit to the commercial sector increasing by more than 20 percent (almost double the 1994 rate) due to the strong and broad-based expansion in economic activity and the recovery in private sector investment, interbank and lending rates have risen. Reinforced by other factors, particularly lower inward remittances of foreign currency assets associated with the depreciation of the exchange rate and the Central Bank's brief intervention in the market, the banking system experienced a liquidity crunch during the latter part of 1995. In response to tightened liquidity, and to foster deposit mobilization and facilitate financial intermediation, the Central Bank took a number of measures to relax credit availability, including lowering reserve requirements from 15 percent to 14 percent, increasing interest rates on resident deposits, and deregulating interest rates for certain term deposits. Moreover, almost all lending

rates can now be set by the financial institutions without Central Bank restriction. Implementation of these measures will further reduce the pre-emption of banking system resources by the Government, improve the efficiency and profitability of banks' operations, and allow market determination of interest rates to provide signals for the allocation of resources.

Policy has also been directed toward further development of capital markets. In March 1995, the Central Bank issued guidelines for a system of primary dealers and specified eligibility criteria, including minimum capital requirements and risk-weighted capital adequacy standards for participating dealers. By November 1995, the Central Bank had already accredited six financial institutions as primary dealers in government securities. Most reform efforts have focused on modifying the institutional framework to facilitate market transactions and increase market turnover, thereby creating incentives for increased depth and liquidity of the capital markets. Further reforms in this area will need to focus, among other things, on deregulating investments by insurance companies and pension and provident funds, and improving the credit rating system for public sector bonds. Implementation of these measures would contribute to increasing the number of active market participants, thereby improving the marketability of financial instruments.

The rate of inflation showed a tendency to increase in the first few months of 1995; however, with money supply growth kept under restraint, inflation receded in later months. For 1995 as a whole, inflation was 9.5 percent compared with 10.1 percent in 1994.

The budget for 1996, which is an interim one pending parliamentary elections later in 1996, provides for an increase of 17.3 percent in total revenue to 11 percent of GDP. Most of the increased revenue will come from customs and excise duties, and company and personal income taxes. The budget made no changes to existing rates of taxation. Total expenditure is projected to rise by 10.4 percent in nominal terms, although this would represent a decline from 16.8 percent of GDP in 1995 to 16 percent in 1996. The fiscal deficit is, therefore, expected to be reduced to 5 percent of GDP. However, capital expenditure will decline further to 3.3 percent of GDP in 1996 from 3.6 percent in 1995 and 4.1 percent in 1994. This is cause for concern. With interest



payments and defense expenditure amounting to over 61 percent of recurrent expenditure, the brunt of any expenditure reductions to reduce the fiscal deficit must fall elsewhere or, alternatively, even stronger efforts than have so far been made will be needed to improve the revenue flow.

Reduction of the fiscal deficit in 1996 as planned will, however, contribute to reducing reliance on Central Bank financing, thereby helping to reduce the rate of growth in the money supply which is expected to be held to about 15 percent in both 1996 and 1997. In turn, and in the absence of supply-side shocks, this should help to bring down the rate of inflation to 9 percent in 1996 and further to 8 percent in 1997.

External Trade and Payments. India's balance of payments has improved substantially following the implementation of the stabilization and structural reform program in 1991. The external current account deficit has declined from 3.2 percent of GDP in 1990 to 0.8 percent in 1994 and, reflecting large capital inflows including private direct and portfolio investment, gross international reserves increased from \$2.3 billion to \$20.8 billion

during that period. In 1995, exports continued to expand, increasing by more than 21 percent. However, imports rose sharply by nearly 27 percent as the progressive elimination of quantitative restrictions and reduction in tariffs – including a further reduction in the maximum and average tariff rates in 1995 – and buoyancy in economic activity was reflected in higher import demand. As a result, the trade deficit widened in 1995, and the external current account deficit is estimated to have increased to 1.6 percent of GDP.

Like several emerging economies, India has experienced surges in capital inflows since 1993. These inflows have eased external constraints and facilitated the pursuit of the liberalization of trade, foreign investment, and industrial policies. By eliminating restrictions on current account transactions, international confidence in the Indian economy has been built up and formed the basis for capital inflows of a longer duration. During 1995, however, net capital inflows moderated, in part, reflecting the adverse impact of the Mexican financial crisis on flows to emerging markets, but also resulting from an increase in amortization to official creditors and repayment of outstanding commercial borrowing.

The bulk of capital inflows continues to consist of direct investment, estimated to have risen from \$1.3 billion in 1994 to \$1.8 billion in 1995. Nonresident deposits with the banking system have also increased. Yet, these capital inflows were not sufficient to offset fully the widening of the external current account deficit. As a result, foreign exchange reserves declined by about \$3 billion and stood at \$17.5 billion in November 1995 compared with \$20.8 billion at the end of 1994. This contributed to pressure on the exchange rate: the Indian rupee (Rs)/US dollar rate depreciated from Rs31.5 to about Rs35 per US dollar.

As the impact of the trade liberalization measures and the effects of the exchange rate adjustment work themselves out, growth in exports is likely to moderate to 18 percent in 1996 and 15 percent in 1997, while import growth contracts to 21 percent in 1996 and 18 percent in 1997. The current account deficit is forecast to increase to 1.7 percent of GDP in 1996 and further to 2 percent in 1997. The projected further increase in non-debt capital inflows, reflecting India's potential to efficiently absorb direct investment, will contribute to moderating the increase in external debt and debt service. The debt-service ratio is projected to rise marginally to 26.8 percent in 1996 and 27.6 percent in 1997.

Policy and Development Issues

The Government has made impressive progress in implementing a comprehensive market-based stabilization and structural reform program. Progress in liberalizing industry, trade, and foreign investment included eliminating quantitative import restrictions, rationalizing the tariff system, reducing entry barriers, and abolishing licensing requirements. In the financial sector, interest rate controls have been almost completely abolished, lending rates have been freed, and the reserve and liquidity requirements have been lowered to reduce the implicit taxation on financial institutions. In addition, prudential regulations have been strengthened and a Board of Financial Supervision established. Progress has also been made in deepening capital markets and establishing an improved regulatory framework. Wide-ranging reforms to the tax structure have also been made.

However, progress has been limited in several areas, particularly as regards public

sector reform. The emphasis so far has been on improving revenues through revising the tax structure and broadening the tax base, but efforts need to be directed toward rationalization of expenditure and reform of public sector enterprises. Reduction in the public sector deficit would lower borrowing costs, release resources for more efficient private sector utilization, and further moderate pressure on monetary expansion.

Equally important is the need to accelerate reform of the public sector enterprises. Growing competition from private sector entities has compounded the financial difficulties of the public sector enterprises and put additional strain on budget resources. Moreover, consolidation of the public finances would contribute to raising domestic saving and lowering reliance on foreign saving, and thereby reduce pressure on the external current account.

Another important area of concern is the inadequacy of India's infrastructure. While higher domestic saving and inflow of capital, and greater efficiency in capital use can accelerate economic growth, it will not be possible to achieve and sustain such growth without massive investment in the development of infrastructure. Inadequacies in the power, transportation, and telecommunications sectors are major constraints. The recent opening up of these sectors to private sector participation, including foreign investors, is a positive step.

Progress in the reform agenda has been limited mostly to the Central Government. The states' public finances have remained under stress because of the inherent structural weaknesses of their tax systems, heavy expenditure obligations, and a slowdown in their access to ad hoc grant transfers from the Central Government. Given that most of the unfinished reform agenda is a concurrent responsibility of the Central Government and state governments, it is crucial that the states make greater progress in their structural reforms.

Although there has been a significant improvement in social indicators, India still lags behind most Asian countries in these aspects. Poverty remains a serious problem; a large fraction of the population has limited or no formal education and there are substantial disparities in social indicators across the states. To sustain economic growth over the long run, much more rapid progress needs to be made in human resource development than has been the case in the recent past.