INDIA

The slowdown in global and domestic demand has taken its toll on the Indian economy, which is now expected to grow at below 6 percent during the current fiscal year. Supply-side structural constraints continue to hamper economic performance and to affect the medium-term prospects for the economy. Progress on fiscal consolidation and an accelerated pace of structural reforms may help move the economy toward a higher growth path in 2002.

Economic Indicator (percent)	**1998**	**1999**	**2000**	**2001**		**2002**	
				Current	***ADO 2001***	**Current**	***ADO 2001***
GDP growth	6.6	6.4	5.2	5.6	6.2	6.3	7.0
Inflation rate	5.9	3.3	7.2	5.0	5.5	5.0	4.8
Current account/GDP	-1.0	-1.0	-0.5	-0.9	-1.2	-1.0	-1.0

Economic Assessment. The global economic slowdown has had a more significant impact on the Indian economy than expected in *ADO 2001*. Official estimates now place GDP growth in 2000 at 5.2 percent, as against the estimate of 6.0 percent reflected in *ADO 2001*. At the end of 2000 and in the first quarter of the current fiscal year, depressed global demand—reflected in the sharp decline of India's exports—contributed to a deceleration in economic growth. Given the relatively low level of openness of the economy, however, domestic demand and supply-side factors have played the key roles in constraining performance. With weaker growth in agricultural incomes, domestic consumer demand has remained subdued. Investment demand has also been weak in the face of structural bottlenecks and uncertainties related to the economic reform process. Inadequate and unreliable infrastructure has continued to constrain industry. High and chronic fiscal deficits and the resulting debt burden, both at the central and state levels, have limited the Government's ability to undertake development expenditures needed to spur growth in the medium term and to realize the economy's long-term potential.

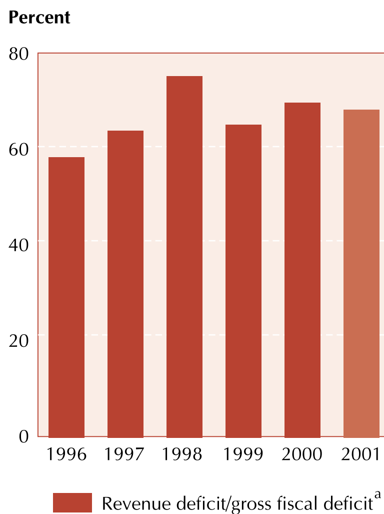
A review of the real economy reveals a continuing lackluster performance of the agriculture sector, which accounts for about one fourth of India's GDP. Value addition in agriculture contracted by 1.4 percent in the last quarter of 2000, a marginally worse performance than during the same period a year earlier. However, the monsoon this year has been above normal and overall rain distribution has been good, with adequate rainfall in the drought-affected states of Gujarat, Madhya Pradesh, and Rajasthan. With agricultural output depending heavily on weather conditions, this encourages expectations for better agricultural performance in the latter part of the current fiscal year.

Low levels of domestic and external demand and weak business confidence kept industrial growth sluggish, at 2.7 percent in the last quarter

2000 refers to fiscal year 2000/01, ending 31 March.

of 2000. Manufacturing, which alone accounts for roughly 60 percent of industrial output, grew by 3.5 percent, less than half the rate of growth during the same quarter in 1999. Nonmanufacturing industry grew by around 1.4 percent compared to 7.2 percent in the same period of the previous year. The mediocre performance of the industry sector extended into the first five months of fiscal 2001. The index of industrial production dropped to 2.2 percent during April–August 2001 from 5.4 percent in the same period of the previous year. The drop in growth was particularly steep in power, as well as in manufacturing.

The revenue deficit remains high as a share of the fiscal deficit



[a]Gross fiscal deficit excludes capital expenditure arising from the interest and management cost of the National Savings Fund's investments in states' securities.

Source: Reserve Bank of India Annual Report 2000-01

In 2000, growth in the services sector decelerated to 7.7 percent from growth rates exceeding 8.0 percent in the latter half of the 1990s. This may in part be correlated with the industrial slowdown. Growth in services was 6.9 percent during the last quarter of 2000.

Exports, which recorded double-digit growth rates in 2000, are now down to single-digit levels. During the first quarter of 2001, they grew by 1.8 percent in dollar terms compared to an increase of 26.6 percent in the same quarter of the previous year. This reflected a decline in both May and June 2001. Mirroring below-expectation industrial performance and low investment demand, imports declined by 1.9 percent in the first quarter of 2001 compared to an 18.1 percent increase in the previous year. The net result was a trade deficit of $1.9 billion for the first quarter of 2001 compared to a deficit of $2.4 billion in the same period of the previous year.

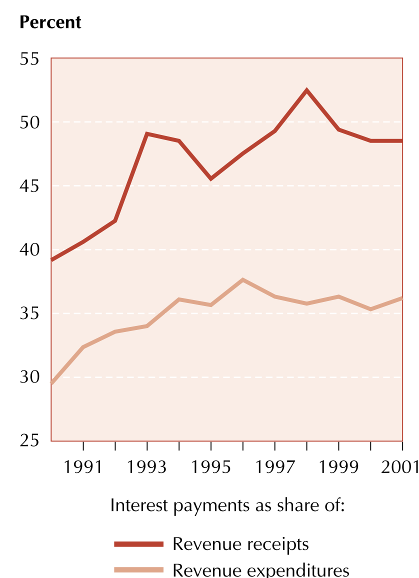
As of 12 October 2001, foreign exchange reserves were at a comfortable level of $44.9 billion. After weakening substantially to Rs48.43/$ following the 11 September attacks, the rupee has been fluctuating around Rs48/$. Capital flows remained stable during the first quarter of 2001, with a marginal decrease in FDI at $608 million balanced by higher foreign institutional investment at $632 million.

The annual rate of inflation as measured by year-on-year variations in the WPI stood at 5.2 percent in early July 2001 compared to over 6.0 percent in the previous year. Lower inflation reflects the easing of administered fuel prices due to softer international crude oil prices and low domestic demand. The CPI for industrial workers recorded an annual inflation rate of 2.5 percent in May, indicating relatively stable prices of most essential commodities. The Reserve Bank of India continued its flexible stance aimed at providing sufficient liquidity to the economy while warding off inflationary pressures. The year-on-year growth of broad money (M3) in July 2001 stood at 17.6 percent. This reflected a higher growth in commercial bank credit to the Government, though commercial bank credit to the private sector decelerated.

Economic Management Issues. The economic slowdown resulted in lower than expected tax collection. Only 14.0 percent of tax revenues per budget estimates were realized in the April–June 2001 period, compared to almost 19.0 percent during the same quarter of the previous year. Combined with measures to pump-prime the economy through accelerated public spending, this has led to higher government borrowing. Roughly 60 percent of the public borrowing program was completed after only one third of 2001.

In April–June 2001, the gross fiscal deficit was over 68 percent, and the revenue deficit roughly 100 percent, higher than their respective levels in the same quarter of 2000. These figures pose a challenge for the Government in realizing its fiscal deficit target of 4.7 percent of GDP as set out in the 2001 budget. Overall fiscal discipline is also critically dependent on performance by the states. Improvements in state finances may be encouraged by the state fiscal reform facility (2000–2004) as recommended by the Eleventh Finance Commission. This facility links the states' access to an incentive fund to their performance in reducing the revenue deficit as a percentage of revenue receipts. The incentive fund is financed by a withholding of 15.0 percent of the yearly grants that the Finance Commission assigns to the states to cover their revenue deficits, and a matching contribution from the central Government.

More and more of the government budget goes on interest payments



Source: Reserve Bank of India Annual Report 2000-01

Fiscal discipline is crucial for investor confidence and for sustaining growth in the private sector. Together with the increase in consumer demand that is expected from improved performance and higher incomes in agriculture this year, an improved fiscal position is a precondition for stronger and more sustainable economic performance. There are two main channels through which high and chronic fiscal deficits affect investments in the economy. The first is high interest rates and crowding out. Although at present, lack of investment demand may be better explained by factors such as low consumer demand, the existence of substantial excess capacity, structural bottlenecks, and the slow pace of reforms, the cost of borrowing considerations will, however, become more significant as economic recovery gains momentum.

The second channel is the quality of public expenditure and its impact on the overall environment in which businesses operate. With total outstanding liabilities of the central Government amounting to roughly 60 percent of GDP, a large and increasing portion of the government budget goes toward interest payments.

The passage of the Fiscal Responsibility and Budget Management Bill, expected this year, should provide a positive signal to the financial markets and help restore business confidence. The Bill provides for a reduction, over the next five years, of the revenue and fiscal deficits of the central Government by 0.5 percent of GDP each year. The revenue deficit of the central Government would be eliminated, and the fiscal deficit reduced to 2.0 percent of GDP, by 2006. The fulfillment of these commitments, and their impact, however, will depend on the extent to which efforts to rationalize expenditures and increase revenues are successful. Downsizing and achieving cost reductions in the large public bureaucracy, along with containment of the total subsidy bill, which amounted to roughly Rs270 billion and constituted 9.5 percent of revenue expenditures in 2000, will be central elements in these rationalization efforts.

On the revenue side, the Government has room for further improving the tax system and its administration. For direct taxes, revenue improvements are possible through the abolition of exemptions and securing higher compliance levels. For indirect taxes, after the introduction of value-added tax (VAT) at the national level, the establishment of uniform VAT in all states (planned for 1 April 2002 in major states) will be a positive development that

is likely to boost revenue collection and limit scope for corruption. Further, the Government needs to make substantial progress in its program of divestiture and privatization of public sector undertakings, both for additional revenues and direct efficiency gains.

While the overall policy and development issues facing the Indian economy have remained the same over the past few months, some areas of policy reform have acquired additional urgency in the face of the current slowdown.

First are agricultural reforms (including liberalization of agricultural prices and exports), removal of licensing requirements, and de-reservation of agroprocessing from the small-scale industry list. Amending the Essential Commodities Act and reviewing the inefficient and costly targeted-foodgrain public distribution system are key to this process, and would have a positive impact on the budget by reducing the costs of food subsidies. To be effective, these reforms should be accompanied by efforts to reduce the dependence of Indian agriculture on weather patterns and improve productivity, through the provision of irrigation and other basic infrastructure services.

Second, the power sector requires reform. Inadequate power infrastructure is a binding constraint on sustained economic growth. Power sector reforms and privatization are needed to ensure that the increase in capacity in the sector takes place in a sustainable manner over the medium term. The burden that the power sector imposes on public sector finances is enormous. It is estimated that the hidden subsidy resulting from lower than economic pricing of power to the agriculture and domestic sectors is Rs250 billion a year. This is roughly equivalent to 1.2 percent of 2000 GDP at current market prices and to 17 percent of the gross (central and state) fiscal deficit in 1999 (based on the budget estimate for the gross consolidated fiscal deficit).

Finally, factor market distortions need to be removed. As trade is liberalized, distortions and inefficiencies in factor markets due to labor, land, and bankruptcy laws hamper the creation of an environment in which Indian businesses can compete with foreign producers.

Forecast. Expectations of a prolonged global economic slump and a softer rebound in 2002 than previously anticipated have implications for India's economic outlook. Indian services sector exports—software and tourism in particular—are likely to suffer from the drop in external demand and heightened security concerns. ICT exports have played an important role in sustaining the current account, and, if they fall, could deprive the Indian economy of a buffer mechanism to counterbalance external shocks such as sharp increases in oil prices. Worker remittances from the Gulf countries may also be negatively affected. Further, political uncertainty in the subregion could deter foreign capital flows. These factors may contribute to a further weakening of the rupee. The stock market, which took a dip in the immediate aftermath of the attacks, appears to have stabilized, albeit at lower levels, but further turbulence cannot be excluded as events unfold.

Given the still limited openness of the Indian economy, however, the possible negative impacts on the balance of payments are unlikely to be very significant, especially when considered in the present context of comfortable foreign exchange reserves and a low current account deficit. Further, the dampening effect on external demand of a deeper and more prolonged global slowdown is likely to be counteracted by a pickup in domestic demand if expectations of a strong performance in the agriculture sector materialize. Revival of agricultural growth would be accompanied by a moderate improvement in industry and services sector performance in the latter part of fiscal year 2001. However, given the increased uncertainty of the global economic scenario, India's GDP growth rate is projected in the range of 5.3 to 5.8 percent in 2001 as against a growth rate of 6.2 percent in *ADO 2001*.

For 2002, GDP growth is projected in the range of 6.1 to 6.5 percent as industry and services sector growth gain further momentum. Realization of the high-end forecast in 2002 would depend, on the one hand, on an improved global environment, and on the other, on the Government's accelerating the pace of reforms necessary both to improve fiscal performance and to address structural issues in the economy. In a domestic environment characterized by stronger fiscal discipline, inflationary pressures might be managed effectively. Under this assumption, inflation would remain moderate, at around 5.0 percent in 2002.

With subdued export and import growth, the current account deficit may be below 1.0 percent of GDP in 2001. Stronger external demand and initial improvements in export competitiveness, due to the progressive removal of factor market distortions, are likely to improve export performance to some extent in 2002. As increases in industrial output may be realized initially through employing the current sizable excess capacity in the industry sector, import growth may be contained during 2002 and, with a stable invisibles account, the current account deficit is likely to be maintained at about 1.0 percent.