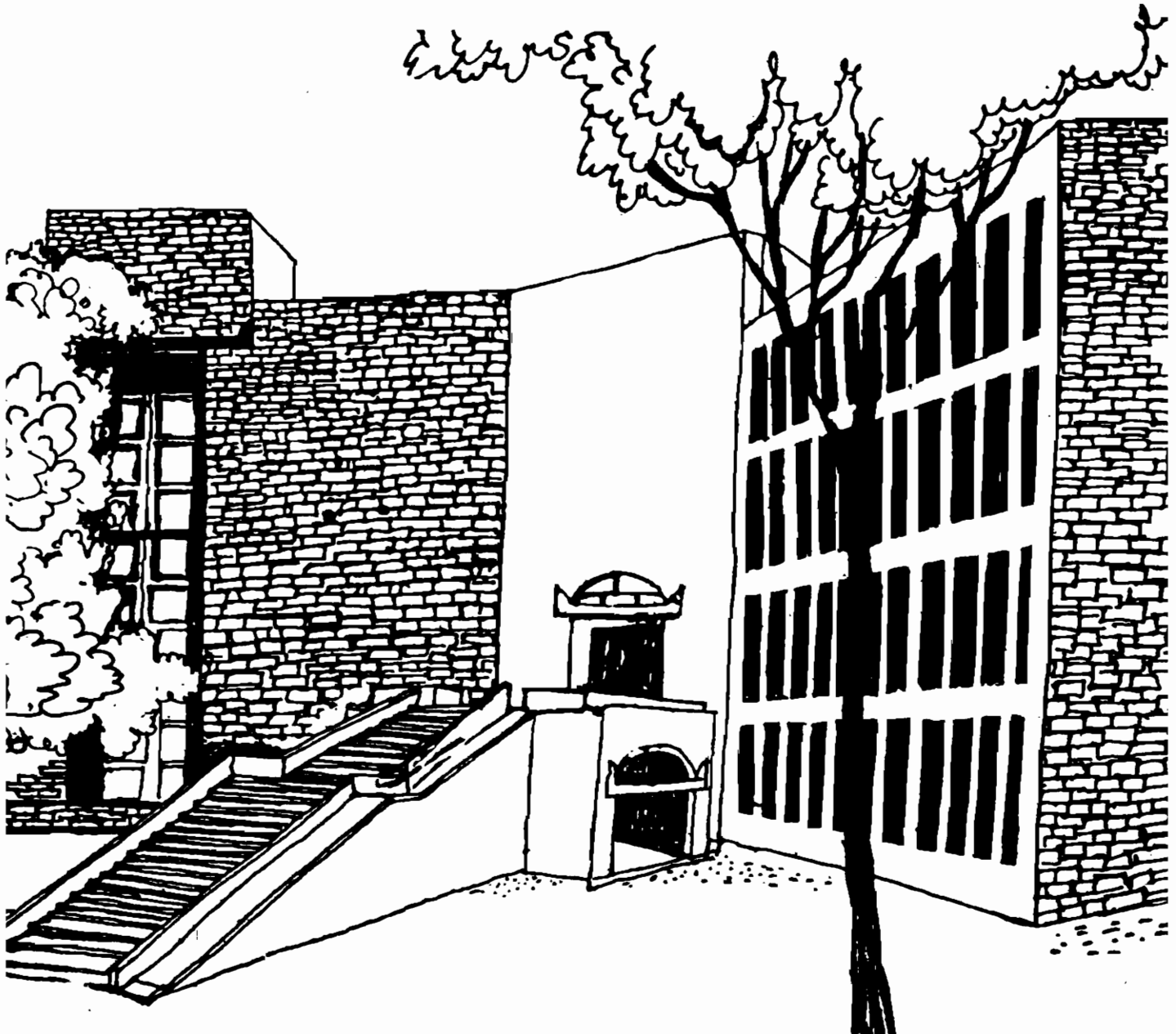




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**INDIAN ECONOMIC FORECAST
DECEMBER 1993**

By

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INDIAN ECONOMIC FORECAST : DECEMBER 1993

by

A.B. Rastogi

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ABSTRACT

The government has begun preparing the people for the second phase of reforms by frequently pointing out that the next phase of reforms would be harsher but enrich their lives later. The tougher decisions about liberalisation in the field of labour law, agricultural reform and privatisation are still on anvil.

The budget is not going to set the markets sizzling. It is widely expected that the next budget would be investor friendly and corporate sector would be given more importance this year. Markets are already discounting that and reaching new heights. Our growth forecast for 1993-94 remains at 4.2% and inflation rate (WPI) around 7.6%. However, balance of payment scenario has changed markedly in medium term as a result of lower crude oil prices, exceptional growth in exports and foreign investments. In medium term, GDP is expected to grow above 6.5% while inflation remains around 6%.

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by

A.B. Rastogi

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Summary

Indian economic reforms have gained momentum again: Direction of reforms is well set and planned. The economic gains made in the last two and a half years in terms of trade balance, controlled inflation and growth would push reforms even further. Political uncertainty which was not allowing economic reforms and foreign direct investment to go ahead full steam has been laid to rest. The voters' verdict is clear, the politicians should deliver what they promise. The present government has two years to show that it can control prices while laying foundation for a sound economy.

A disparate group of businessmen, politicians and academics are questioning the pace of reforms. It is unlikely that the pace of reforms would get a knocking as and when the reforms force distortions to surface, the affected interest groups are expected to fight the rear guard action rather than lead a front assault. This is true not only in India, but also in developed countries.

Financial sector reform is proceeding apace. That is the signal being given by the RBI Governor Dr Rangarajan. But he would like to see the rupee convertibility on capital account in 3-4 years time. One probable reason may be the legitimate concern of central bankers who would like to regulate off-balance sheet items of commercial banks balance sheet. Anyway, financial system has to be liberalised further and fiscal deficit has to be reduced before rupee is made convertible on capital account.

The flow of goods have made it inevitable to form trade associations. The US is the leading export market for many Asian countries and America now exports more to Asia than it does to Europe. The Asian-Pacific Economic Co-operation (APEC) leaders have called the next century to be the Asian century. Their dream would come true only if APEC adheres to multi-lateral free trade as per its preamble and in turn strengthens GATT, the finishing line of all free traders. The visible signs of bargaining strength of a trading block is propelling India to be a member of APEC and form Indian Ocean Free trade Area.

The budget is not going to set the markets sizzling. It is widely expected that the next budget would be investor friendly and corporate sector would be given more importance this year. Markets are already discounting that and reaching new heights. Our growth forecast for 1993-94 remains at 4.2% and inflation rate (WPI) around 7.6%. However, balance of payment scenario has changed markedly in medium term as a result of lower crude oil prices, exceptional growth in exports and foreign investments. In medium term, GDP is expected to grow above 6.5% while inflation remains around 6%.

1. Economic Reforms in the Mid-stream

Indian voters have convincingly rejected sectarian dispute and have shown that they are interested in getting on with their work. There is a lesson here for politicians that the best electoral strategy is to make India richer and more competitive. The good performance of the Congress may be interpreted as a nod from the public on economic liberalisation. The Finance Minister has stated that he is going to return to reforms with renewed vigour. The 'Letter of Comfort' which is accepted by the Asian Development Bank (ADB) to clear US\$ 250 million capital market development loan suggests that the reforms are going to be accelerated now and whatever slippage has occurred would be taken care of soon. The loan is expected to be cleared in the second week of December by the ADB, the Finance Minister is expected to present before Parliament the details of the loan after its approval. The booming stock markets in the past one month, though an unreliable and a fickle indicator, suggest confidence of foreign institutional investors in economic management and political stability of the country.

Even though the liberalisation train may seem to be slowing down and to a myopic observer may appear to come to a halt, it is not so in reality. It is chugging along and should move faster now. The government seems to be following a strategy where by giving licenses to some high profile multinational companies like Coca-Cola, McDonald and Wimpey, a message is being sent out that India is no more a close market. The praise being bestowed by foreign politicians, foreign businessmen, trade delegations is that the message is getting across. Domestic producers should pick up the cue that they should brace themselves for international competition.

Better than expected showing of Congress has strengthened the Central government. Privatisation and globalisation would get a boost now. The issues which the Parliament is going to consider in the winter session are GATT talks in Geneva, reform package for the drug industry, the sale of public sector equity to public and the industrial relations bill.

It is widely believed that India with good economic institutions and cheap skilled manpower has potential to achieve very high growth in a short span of five years. These underlying factors have attracted our neighbours too. For example, Omani's proposal for a gas pipeline and Iran's offer to provide transit facility to help India's trade with Central Asia must be seen in this light. After the lifting of trade sanctions against South Africa, their businessmen are scouting for business opportunities. To consolidate the gains the Prime Minister is expected to lead a high level delegation to Britain and Germany to directly interact with the chief executives of multinational corporations and government functionaries. Telecom sector is being thrown open to private sector. Improvements have occurred in the past two and a half years but a transparent and well thought out strategy would have given a clear signal to investors.

In the financial sector the thrust of the new policy is to grant more functional autonomy to the banks. Lending norms have been changed: banks are free to decide the inventory levels and receivables norms of a company and also the period and quantum of ad hoc credit limits without levy of additional interest. Companies can issue Commercial Paper (CP) for maturities between three months and less than one year. Besides, both the minimum net worth and minimum working capital limit are also being reduced from Rs.5 crore to Rs.4 crore. Though lending and deposit rates have been left untouched, the ceiling on borrowing through Certificate of Deposits

(CDs) has been removed with effect from October 16, 1993. The liberalisation of the market in CPs, CDs and the entry of financial institutions into the short term money market have led to a revival of the stock market. The licensing of private sector banks by the RBI must be seen as a major reform in line with the Narasimhan Committee Report. Furthermore, twenty-five urban loss making branches of United Banks are ordered to be closed by RBI before US\$ 70 million bail out loan is granted.

In a sweeping change foreign brokers have been allowed by Stock Exchange Board of India (SEBI) to operate in Indian stock markets on behalf of foreign institutional investors (FII). Despite a tax of 30 per cent on short-term gain on portfolio investment, India is expected to receive US\$ 2 billion in 1993-94 which is not difficult to achieve. In the two weeks after Diwali alone FIIs have invested about US\$ 100 million in Indian stock market and their total investment stands at the level of US\$ 750 million now. The transparency and accountability have become buzz words in the financial sector. The SEBI is forcing brokers and other financial intermediaries to do it and 30 million Indian shareholders are demanding better service. Foreign investors are providing financial muscle and cutting edge to it.

According to a survey conducted by the US-Indian Business Council, among fifty Fortune-500 companies, the US industry is very keen to have business operations in India. Entry of foreign newspapers, in a way, can be interpreted as an endorsement by international newspapers of the new economic policies. Singapore is eyeing India for investment in the field of port development, telecom, electronics and financial services sector if greater reliance is placed on private initiative.

The discovery of Indian market as one of the hot markets by Fortune magazine, investment firms like Merrill Lynch and McKinsey etc. is a signal that if the economic reforms are brought about as promised, the Indian economy can become a vibrant economy. Foreign governments like Germany and Britain too share this perception. The reason for this optimism is that the example of Chinese liberalisation process in the last fifteen years has proved that an economy as large as China, given the compatible incentives, responds according to the tenets of neo-classical economies. At present, after a break neck growth of Chinese economy in the last three years, it is in an economic mess due to lack of economic institutions like a Central Bank to control monetary policy, or legal framework to spell out responsibilities of central government and regional government, property and ownership laws and lawyers to interpret them.

In India, the question being asked is why is China outpacing India? How can a country with skilled and cheap technical personnel lag so far behind countries with less capable human resources? Indian administration is also taking into account what its competitors are doing. Ministry of Industry has commissioned Price Waterhouse to undertake a comparable analysis of the investment promotion zones in Indonesia, Malaysia, Thailand and China. The economic reforms are geared up to attract foreign direct investment (FDI). The reason being that even in the US, Japanese investment has changed industrial sector. A study on labour productivity carried out by McKinsey Global Institute concludes that intense competition from Japanese car makers has made American car industry more productive. The study further found that foreign direct investment rather than world trade stimulated domestic industries to become more productive. The reason suggested in the report is that new management and working practices brought about in the foreign owned companies were widely dispersed as employees moved from

the foreign firms to local ones. The economy benefited by achieving levels of labour productivity at par with foreign workers. The US is again exporting cars, except that the main exporter is Toyota rather than Ford or the General Motors. Similarly, FDI has transformed Malaysian economy altogether. From a labour surplus economy it has become an economy short of labour. It is in an enviable position now, where unemployment rate is as low as 3 per cent. This has not happened over night. It took ten years to achieve it and the Malaysian economy has reached the same level of progress as the South Korean economy.

To attract FDI, the government has entered into bilateral financial guarantees with the US, the UK, Germany and South Korea. The guarantee has emerged as one of the key elements influencing the flow of FDI. With recession continuing in the West in 1993, the world-wide FDI from the developed countries may not reach US\$ 38 billion peak achieved in 1992. Competition for funds is hotting up and all barriers to FDI, real or imaginary, need to be removed. India has to compete with industrial countries also for FDI. Recently World Economic Forum has declared North East England as the best place for FDI anywhere in the world.

The action on 'hard options' of the second phase of the government is awaited. In the second phase, reforms have to be brought about to lower interest rates to levels prevailing in world markets and carry reforms to the state level, where most of the economic and industrial activity takes place. Hence, not only central government but state governments too have to agree for reforms to go ahead. Over a period of last one year or so, states are facing financial crunch as they are not able to get rolling overdraft facility from the Reserve Bank of India. They are worried about their sources of revenue which may dry up if new reforms are implemented. On the other hand, their expenditures are not waning, if at all, these are rising. Some states are using innovative methods to curb their expenditures but given loss making electricity boards, state transport and irrigation system around their necks like mill stones, they do not want to lose any money, which they get as subsidies from the centre by keeping loss making units running. Therefore, the wealth which is locked up in the fixed assets, especially land, cannot be utilised at present. Even now, an entrepreneur - foreign and domestic alike - has to approach the state government for various approvals. These include permission for site, power licences and environmental clearances. Tax incentives too are provided by state governments and to get these is not only time consuming but requires tedious interaction with state bureaucracy. A survey carried out in October by National Council of Applied Economic Research (NCAER) suggests that as many as 60% of the industries feel that there are no changes in state and municipal regulations.

Apart from labour there are few costs that are not equalised by trade across nations. The only elements that can offset labour differentials in the location of industry are infrastructure, including legal system which underpins the property rights and particular resource advantages such as fossil fuels. Some of the states have realised this and competition among states is hotting up. The state of Gujarat is going to engage either McKinsey or Arthur Anderson consultancy firm for preparing a detailed blueprint on the state's infrastructure needs. McKinsey has already prepared a report on infrastructure needs of Maharashtra state.

Competition among states is not the sole answer. India should have a competitive industrial structure as well where labour and capital are free to move. The vastness of industrial sickness

in India is a result of forcing labour and capital to be immobile. The problem of industrial sickness is grave because in the last 30 years government has not allowed sick units to be closed down or taken over, instead they have pumped subsidised public money into it. This gave incentive to 'promoters' not to revive sick units but get subsidised capital and use it elsewhere as arbitrage opportunity existed. The situation is changing rapidly in the liberalised milieu. The IDBI, one of the main term lending institutions is encouraging mergers or closures of sick units now rather than reviving them.

The reforms, on one hand, are attracting attention of foreign investors - direct and portfolio investments - on the other hand, pessimists are warning about bad time to come and a disparate group of businessmen, economists and politicians are raising the flag of protectionism and nationalistic economy. It is widely feared that once industrial growth picks up, imports would start growing about one and a half times that of GDP growth rate and hence trade deficit will start rising again. Coupled with debt repayments between 1995-96 and 1996-97, India would again find itself amidst the foreign exchange problem. There is no answer for inveterate sceptics and pessimists. Indian politicians may moan about consumerism tendency as a betrayal of the Gandhian ethic. But if they can betray Gandhi for the sake of power and money, they hardly have a moral right to blame the people, who strive for achievement, opportunity, comfort and leisure.

Domestic producers who did well so far under protected environment are feeling chill wind of competition. The threat of extinction concentrates the mind wonderfully. It is the take-over fear and losing control of their companies which has propelled many industrialists to call for changes in the companies act. In a nutshell, if these companies are under valued they are sitting targets for take overs by foreign institutions as many of these firms have got a very small proportion of promoters' contribution. Therefore, there is a demand for non-voting shares and allowing promoters to borrow against shares held by promoters. The first instrument would allow them to raise equity without fear of losing 'ownership' of the enterprise and the second instrument would allow them to increase their stake in the company. The threat of takeover is a stock market control on the owners to ensure that assets are optimally utilised. The changes proposed by Indian businessmen would neutralise this threat. Hence, on the grounds of economic efficiency take-overs and mergers have to be allowed but in the past Indian owner's equity got diluted because of the MRTP act, wealth tax, licensing system and conversion of loan into equity by financial institutions. The upshot is that existing companies should be given some breathing space. In fact, just like in Japan and Germany, the companies are entering into strategic alliances with financial institutions, which have substantial holdings, who are going to favour existing management in the takeover battle. The Industrial Credit and Investment Corporation of India has declared that it will favour the Indian promoter if the company is well managed.

Another demand of industry captains is to have a level playing field in terms of interest rates, infrastructure facilities - electricity availability, sales tax, excise and so on. The argument is that in one go you cannot expect them to be competitive. Many business economists agree with them. But, one must not shy away from the ground realities. The economic reforms would force industrial restructuring and uncompetitive businesses will have to pull down shutters. The supporters of 'level playing field' need reminding that many of these industries have enjoyed subsidised capital and fiscal incentive for a very long time. Today, they may not be able to

compete due to locational disadvantage, outdated technology or high cost structure. But all is not lost for past masters. They still have fixed assets and intangible assets worth billions of rupees. Government should allow them to restructure their business and become competitive. Therefore, there is the necessity of bringing reforms at state level which addresses the question of land and labour.

However, the reforms in the agricultural sector have been slow. Major areas of policy reforms in agricultural sector relate to subsidies, support prices and foreign trade. In fact, the reason why 'farmers' union' leader Sharad Joshi is in favour of the Dunkel Draft proposal is because agricultural sector, given freedom to trade freely within and outside India would benefit far more than under government's so-called 'food-security' policy. The gradualist approach of the Indian government towards economic reforms is not a choice but compulsion in our economic system but it should be completed in the life time of present parliament. World would not wait for us to catch up with them.

2. Capital Markets

Whereas governments want to facilitate freer movement of goods by building trade blocks, they would like to erect barriers to stem the free flow of financial capital. Alas! barring draconian measures, no barrier is strong enough to withstand the tidal waves of capital flows. This, coupled with the problem of time inconsistency, has left monetary policy without an anchor on the high seas. The only way to keep afloat is to follow a stable monetary policy.

Speaking at the Indo-US Joint Business Council in November, the Finance Minister indicated that the rupee would be made fully convertible on capital account within two years and said it may also happen within a year. The RBI governor speaking at Ahmedabad before the Finance Minister's statement had suggested that rupee convertibility on capital account is 4-5 years away from now.

One should look at rupee convertibility keeping in mind the capital markets and the advantage it offers. The experiences of Latin American countries like Argentina, Chile and Uruguay suggest destabilising nature from free flow of capital; the experiences of Mexico, New Zealand and Korea support the strengthening of the economy from the convertibility of currency on capital account.

Derivatives is the new buzz word in the financial sector in India. Their use would increase as banks are allowed to hedge their bets in forex market. But not all central bankers like them and feel that derivatives introduce 'systematic' risk in the financial markets; but given the calculus of derivative markets it is hard to show it. What is to be recognised is the international nature of these instruments and stock of funds which back them. The market in derivatives got developed to take care of variability in interest rates, exchanges etc. which were the outcome of government's renegeing on their monetary and fiscal targets. Now these derivatives have the upper hand, in the sense that, if operators in the market smell any 'time inconsistency' or even an inconsistent conviction of monetary or fiscal authority, the large financial capital movements force the hand of monetary authorities as no country has foreign exchange reserves which can

take on the might of multi-trillion dollar derivative market. Regulators world-over are at a loss to assign risk which is undertaken by banks over-the-counter derivatives as the nature of risk is not well understood and hence eludes them of effective management and regulation. This business is a new growth area for profit generation. In fact, some banks in India who may show loss this year are thinking to start this operation to bring back their sagging profit line.

The play of free capital can be seen in the South East Asian bourses during the last few months. Thailand, Malaysia and Hong Kong stock markets soared last month as a result of the US money pouring into these markets. The presence of two giants: the Chinese and the Americans, have changed the character of the Hong Kong market and as they flex their muscles new rules of the game are being written. Big American players like Morgan Stanley with very large capital base have set the rules of the game in the Hong Kong bourse. The use of derivatives allow arbitrageurs to shift between the futures and cash markets and hedgers can cover their short positions by writing call options. Liquidity from the US and Japan is propelling the Hong Kong market. Nobody wants to think about what would happen when the US interest rates go up. The bull run is fuelled by developments that have little to do with Hongkong.

Given the complexities of capital markets now, the RBI Governor has reiterated the need for upgrading the skills of bankers in order to cope with the increasing sophistication and internationalisation. A beginning has been made. The authorised forex dealers would be able to write cross-currency options for their customers. This would allow corporates to hedge themselves against exchange fluctuations.

Before capital account convertibility takes place the following reforms must be in place. First, the fiscal deficit should be reduced to such a level that inflation is under control and structural reforms have been done to bring relative prices in line with world prices. Second, trade liberalisation through rationalisation of tariffs should be attained to achieve globally competitive industrial structure. Third, financial institutions with sound bottom line should be there. Fourth, a market determined interest rate yield curve is needed because forex movements are primarily driven by interest rate differentials in forex markets. In India, at present the exchange rate is 'determined' by demand and supply position in the market. ↘

We have outlined the complexities which would come when rupee is made convertible on capital account. But there are some substantial advantages too. Most important among them is that it would attract substantial investment in the core sector. Four years from now may be too late as international investors are looking for investment opportunities now. Many foreign investment analysts and companies feel that the liberalised economic environment does provide such an opportunity.

Mr Barton Biggs, Chairman of Morgan Stanley Asset Management, whose assessment of China has set Hong Kong stock market sizzling, expects return of 15 per cent to 17 per cent on its investment in Indian equities this year. This was in the first week of November 1993. Probably this he may have got in the month of November itself. But more important is his assessment that Indian capital markets are more mature, sophisticated and less risky compared to China. His company would like to invest in power generation, telecommunication and consumer goods. The assessment of Indian market is corroborated by Mr. M. Mayya's long-term prediction. His prediction is that the market capitalisation is expected to increase every year by at least 35 per

cent partly due to appreciation in prices (about 20%), partly due to fresh offerings in the market by new and old companies (about 10%) and partly due to disinvestment of shares of public sector undertakings (about 5%) until the end of twentieth century. But a discerned reader would distinguish the difference between the two assessments. Mr. Bigg is referring to short-term gains and Mr. Mayya is talking about growth of capital markets based on underlying economic strength.

The ability of companies to issue GDR at par with BSE prices is an indication that capital markets are coming of age in India. But, there is a downside risk with foreign portfolio investment and capital mobility. As stated earlier, apart from political stability, market sentiments largely depend on credibility of monetary policy.

Just after the 1992-93 budget was presented, economic analysts were elated and they expected economy to grow somewhere around 6 per cent in 1992-93. We know that exports have been growing rapidly, inflation is in single digit, economic growth has been further helped by good monsoon, then why has the growth rate been scaled down to 4.5 per cent for 1993-94? Why have those over optimistic economists got an egg on their face? A crucial feature of an economy is that the current events depend upon anticipated future policies if we believe that economic agents react intelligently to available information. In technical jargon economists call it 'rational expectations'. This gives headache to policy makers in formulating optimal policy rules; as they need to take into account private behaviour of people's expectations about the outcome of the rules.

The call for an independent RBI is based on the fact that in an open economy credibility of economic policy depends on whether policy makers are bound in some way to stick to their stated policy. As politicians many a time renege their previous commitment, especially the ones which are required to maintain price stability, an independent monetary authority is more likely to follow a consistent stated policy. Chinese somersault is a good example of this. An independent monetary authority, however, can build up credibility by following past commitment, to deliver a commitment in future. This building-up may be costly in terms of lost flexibility but it reduces distortions which makes renegeing ~~at~~ attractive and offers unlimited opportunity to arbitrageurs. An independent Central Bank would provide distinction between power to print money and the power to spend it. This shall make the bank independent and accountable.

Capital market reforms and need for an independent monetary authority should be seen as two sides of the same coin. Explosive growth in international financial transactions has added the risk of economic instability. Aided by modern technology and growth in areas like derivatives, these transactions have increased so much in speed, scope and complexity that they vastly exceed the level of international trade in goods and services. Untrammelled capital movements have been an important factor behind the two crisis in the Exchange Rate Mechanism in September 1992 and July-August 1993. It is no exaggeration to speak of an abdication of democracies in the face of anonymous, uncontrolled market forces.

3. Regional Trade Blocks and India

Regional free trade blocks are in fashion now-a-days. So far, India is not a member of any of these blocks. Not that India would not like to be a member of these clubs, it is just that, as yet, India is not acceptable as a member. Its application is pending with Asia-Pacific Economic Cooperation (APEC), but it could not be considered at Seattle, as the members had more urgent matters to discuss. As we noted in our last working paper, Bhagwati in his paper on India's economic reforms had recommended that India should become a member of one of the trade blocks and form strategic alliances with other trade blocks to bargain a better deal for itself. India is eagerly waiting to become a member of APEC and the visit of Singapore PM Mr Tong to India is a serious step towards strengthening its ties with South East Asian companies. Singapore, too, has shown interest in FDI in India as a global sourcing for its industrial and consumer electronics products.

The bottom line of all these trade blocks is that members of a block want to have a market bigger than their home market for their goods and services as well as high protection for politically sensitive goods. In simple words, they want to have their cake and eat it too. Problems emanating from regional trade/free economic areas give rise to insurmountable problems at world stage. Let us look at the bare economic facts of APEC. The US at present does more trade with the Asia-Pacific countries than with the North Atlantic countries. By the end of this century the US trade with the Asian countries is expected to grow two folds while trade with the European countries will remain at the present level. As trade with the Asian countries is growing the US wants to negotiate a preferential access for its goods in these markets. No doubt the success of these economies -- Japan in the past and China now -- got piggyback under the most favoured nations (MFN) status granted by the US. The MFN status is the most sought after even today as it opens the door to the US market consisting of about 250 million consumers. The APEC idea floated by ASEAN countries was to have it as a loose organisation where trade related talks could be aired and not as a new trade block in competition with EEC or GATT. It is perceived that the US has taken out an insurance policy by having North American Free Trade Area (NAFTA) and has used APEC platform to become an alternative to GATT.

The US wants to make APEC the first step towards a Pacific Free Trade Area. The ASEAN countries (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand) have just managed to start an Asian Free Trade Area with a 15 year grace for the members within which the members would reduce the tariff. Hence, the notion of a bigger free trade area would go to an intensive care unit soon after it is born. However, a forum where leaders can have one to one talk is useful whether they issue "vision statement" after their confabulation or not. Many APEC members have stressed that all the activities under its banner should be consistent with GATT. If so, why do we need a mini GATT? The American view is not prevailing as the Seattle meeting was boycotted by Malaysian Prime Minister Mahatir, who does not want to pass on the leadership of the whole of Asia-Pacific to the US. Already a proposal is at an advance stage to launch yet another group called the East Asian Economic Caucus (EAEC). It has been proposed by Malaysia and is expected to be launched next year. It shall have all the six ASEAN countries and the other prospective members are China, Japan, South Korea, Taiwan and Hong Kong. The caucus would build linkages within the region before building an effective bridge

across the Pacific. Malaysians view that EAEC dovetails into the APEC process which in turn dovetails into the GATT process.

Many Asian countries blame Europe for stalling the GATT talks and they need multi-lateral trade agreements and a liberalised economic environment to continue to grow. Asian leaders recognise that the world economy has changed and that the source of future world economic growth is Asia. The centre of gravity of global consumption and production will shift from rich to developing countries. This shift will reflect in part the rapid growth in productivity in latter. It will also reflect changes in relative prices, wages and exchange rates. Japanese economy -- an important part of Asian economy -- is suffering from deep recession right now and may take more than a year to come out of this. Hence, the implication is that the economies of China, Indonesia and Malaysia with their large domestic market can provide a big push to the ailing world economy.

GATT seems to be a victim of its own logic. The system was designed to give political mechanism to nations to defeat protectionism at home. The Uruguay round has faced the difficulties because the main proponents have overlooked the GATT's logic by creating regional trade blocks.

The Organisation for Economic Cooperation and Development (OECD) has estimated that the world would gain US\$ 270 billion from year 2002 onwards if the GATT talks are successful. The development of a global trade system based on trade blocks cannot be in the interest of India. At present, the EC and NAFTA markets account for little less than fifty per cent share of India's exports. India's chances of becoming an effective member of a powerful trade block are remote. Hence, it is in India's interest to push for a successful conclusion of the Uruguay round. There is no doubt that the NAFTA would change the future course of world trade. At least, it has become apparent that regional alliances are strong enough to counter the traditional divide between developed and developing countries.

The success of the Uruguay rounds would address the issues of agriculture, textiles, patents and services which would benefit India in the long-term. Market access of its products in the developed countries is of immediate interest to India. As noted earlier, India would like to be a member of APEC and she has toyed with many regional trade blocks. In fact, a study carried out by the South Asian Department of the World Bank advises India to join either NAFTA, EC or APEC because when policy makers, especially in the US, talk about Asia they mean East Asia. India and South Africa are generally forgotten in the dialogue for regional trade groupings.

The South Asian Free Trade Area (SAFTA) did not take roots so far as there is not much of trade among these countries and therefore, mutual benefits derived by having such an area are minimal. Given this background what are the advantages of proposed Indian Ocean Free Trade Area (IOFTA)? The IOFTA has proposed for internal trade within the group, protecting domestic market and to bargain with other and may raise tariff against others. In fact, it is the bargaining power of a regional trade block which is of interest to India and South Africa. Additionally, India and South Africa would like to secure their economic future in the medium term if regional trade blocks become important players in the world trade.

4. Budget 1994-95

With the hindsight of the emerging new trade alignments, reality of capital market and past promises of the Finance Minister and other policy makers, we have tried to put together the propositions which are likely to find their ways in the 1994-95 budget. Of course, some surprises every Finance Minister wants to pull out of his hat, but there are limits to which he can go. The Finance Minister is on record that bulk of exchange controls are ineffective and expects that full convertibility on the capital account would eliminate the hawala market. Rupee convertibility on current account is a serious contender and convertibility on capital account has to wait a little longer. Probable reasons for that have been expressed earlier. It has now been recognised by the policy makers that so far all the controls, rules and regulations have been 'anti-employment' and the only way is to dismantle these regulations and emphasise growth which would generate employment. This realisation is based on the study that in exports sector star performers have been garments, gems and jewellery, where the government was not in picture. This has an important implication for the government; a government cannot pick up winners as it requires inordinate amount of market information and process it. This in a way is limitation. However, what government can do is provide a stable and conducive environment where business and trade can prosper.

The Finance Secretary Ahluwalia has suggested that wherever there are anomalies in the tariff structure, the government will try and remove this. Government regulation has discriminated against capital accumulation so far. Coupled with subsidised capital available to industrial sector, companies have been encouraged to borrow from financial institutions instead of raising equity capital. This has resulted in small holdings by promoters in their own companies. Therefore, the 'Bombay Club' has suggested to the government to introduce non-voting shares, so that they can raise equity without losing control of their organisation. Another demand to remove restrictions on inter-corporate loans and investment is to ensure that the promoters do not lose control of their companies. To raise bank loans against their equity is frowned upon by the central banker and rightly so. Even if it is allowed by the central bank, it is unlikely that any commercial bank would bite the bullet. Of course, SEBI is working on code of practice for take overs, such that the take overs are transparent and in the interest of the company and shareholders.

The industry has suggested to have planned cuts in duties but it should be "gradual keeping in view the interests of the indigenous industries". They have urged the government to safeguard the interests of domestic companies when opening up the economy to foreign direct investors. The aim is to reduce all duties and where finished goods attract lower duties than intermediates, there would be countervailing duties to balance it. Most of these issues are expected to be addressed in line with the Chelliah Committee report.

The Finance Minister has further emphasised that he has unfinished business of bringing about a reform of the corporate tax structure. If the corporate tax rates are brought down in line with the Chelliah Committee report, the corporate tax rates should have been brought down to 45 per cent in 1993-94 budget by removing surcharge and in 1994-95, according to the report, the rates should have been brought down further to 40 per cent. There are good chances that the Finance Minister may take a leap and reduce the corporate rates to 40 per cent as this would improve

profitability of the existing companies. This would also give impetus to realisation of commitment of foreign direct investment in the country. The fact that China has already reduced corporate tax to 33% would not go unnoticed. Usual inflation adjustment to income slabs is expected and removal of surcharge on higher income is widely anticipated.

The policy of reservations of items to manufacture in the small scale industrial sector exclusively may not be scraped in one go but the list may become outdated if government allows enhancement of capacities through investments of plant and machinery, provided it generates incremental exports of about 50 per cent of total turnover. This way, the products, small scale industries are already exporting, would virtually go out of the reserved list. As many as 850 items may be affected by this.

6. Forecast

Our growth and inflation forecast has marginally changed but the current account scenario has changed as a result of commendable export performance and lower than expected crude oil prices. The higher growth in agriculture sector is counterbalanced by lower growth in the industrial sector in the first half of 1993-94. A sharp pick-up in industrial growth in the second half of 1993-94 is on the horizon. Although world trade is suffering from recession hit Germany and Japan, its effect on Indian economy is offset by a competitive rupee and low crude oil prices. The growth expected to be only 4.2% and the price level (WPI) is expected to go up about 7.6% in the current fiscal year.

6. Exogenous variables

6.1 World Interest Rates

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The IMF and OECD have revised their forecast downward for world GDP growth to 1 per cent in 1993 and in 1994 it is expected to be 2 per cent only. This too may be optimistic as recession in Japan, France and Germany has not bottomed out, and the experience of other countries suffering from debt inflation (the UK and the US) suggests that recovery will be muted. The falling interest rates may try to maintain recovery. The brightest news comes from Asia excluding Japan. GDP forecast for Asian developing countries is 8.7 per cent for 1993 and 7.1 per cent for 1994.

The fillip in the US recovery in the third quarter has given rise to the fear that the Fed may tighten the monetary stance and may raise interest rate. However, this may not materialise this year but in 1994 there is a good possibility of US short-term rates to be raised by the Fed to cancel out inflationary pressure. The OECD believes that the Federal Reserve should tighten the monetary policy and raise short-term rates to almost 5 per cent by the end of next year from 3 per cent level at present. Increase in interest rates as much as this is not expected. Recent comments from the Fed suggest that it has decided to put more emphasis on real interest rates as

a policy guide. Part of the reason why rates were cut so low was to allow banks which were financially fragile to raise their interest rate margins and hence improve profitability. The result is for everyone to see now. The US banks are now among the best capitalised in the world.

The world economy is in a period of low inflation not witnessed since the 1960s. Bond yields are very low reflecting the expectation that inflation will not rise quickly as developed countries come out of recession. One of the reasons for such expectation is that governments are trying hard to reduce deficits.

Table 1: Exogenous Variables

	1991	1992	1993	1994	1995	1996
World						
Trade growth (%)	1.5	1.3	3.2	5.8	5.8	6.0
Real Short-term Interest Rate	3.1	2.0	2.0	2.8	3.0	3.2
Real Long-term Interest Rate	5.4	4.2	3.8	3.5	3.5	3.5
O.E.C.D. Inflation	4.3	3.0	2.8	2.9	2.9	3.0
Crude Oil(\$/barrel)	18.3	18.4	16.6	16.0	17.0	17.0
Domestic						
Rainfall	91-92	92-93	93-94	94-95	95-96	96-97
(% of normal rainfall)	92	94	101	92	92	92

Table 2: Forecast

	91-92	92-93e	93-94f	94-95f	95-96f	96-97f
GDP growth (%)	1.2	3.1	4.2	6.2	6.4	6.6
WPI (%)	12.8	9.5	7.6	6.0	5.7	5.5
CPI (%)	13.9	12.5	8.7	6.8	6.3	6.0
Exports (%GDP)	7.2	7.7	9.0	9.5	9.9	10.4
Imports (%GDP)	7.8	9.1	9.1	9.5	9.9	10.4
Current a/c (%GDP)	-0.9	-2.1	-0.9	-1.1	-1.0	-0.9
Current a/c (\$ bill)	-2.1	-4.9	-2.1	-2.7	-2.8	-2.9
Exchange Rate (Rs/\$)	24.5	31.5	31.5	32.6	33.4	34.0
Production (growth p.a.):						
Agriculture	-2.4	3.6	4.4	2.4	2.3	2.3
Non-agriculture	2.8	3.0	4.1	8.1	8.2	8.5
Investment (% gdp):						
Private Sector	13.4	13.2	15.5	16.6	16.0	16.0
Public Sector	10.9	9.5	8.7	8.2	8.1	8.0
Govt. expdt. (%gdp)	30.6	31.5	31.2	31.0	30.8	30.7
(Central + State + UTs)						
Fiscal deficit (%gdp)	6.0	6.1	5.7	5.2	5.2	5.2

e - estimated figure

f - forecast figure

6.2 World Trade

A report from Germany's six leading economic institutes published in October suggests that the German economy would shrink by 1.5 per cent this year and would grow by 1.5 per cent in 1994. If this happens the EC economy would grow about 2 per cent in 1994. Earlier OECD had estimated the economic growth of the EC about 1.25 per cent this year and between 1 per cent and 1.5 per cent in 1994. More recent data on Japan has dashed the hopes of earlier recovery in Japan. The new fiscal package has not brightened the prospects this year. The sharp cut in discount rate from 2.5 per cent to 1.75 per cent is not reviving the ailing economy.

The majority of the growth in 1994 will be the result of the continued upturn in North America. The rapid appreciation of the Yen will hold back growth in Japan whilst the tightening of fiscal policy will do the same in Germany.

6.3 Oil Prices

OPEC has almost lost its credibility given its history of over-producing and not sticking to quota levels. Non-OPEC output has expanded considerably and oil companies would not write off the money already invested in long-term expansion plans. North Sea oil production has been increasing in the last eight years. Production increased by 65 per cent and there is no sign of it reducing in short term. Demand is weak and supply is plentiful - a classic situation. An increase of 2 per cent to 3 per cent growth in world GDP would lead to 1 per cent to 1.5 per cent increase in oil demand, which is not much to absorb the oversupply of crude oil. The oil demand has not picked up due to slow economic growth in the industrialised countries. Over supply of oil exports from Russia has further added to the problems being faced by the oil market. OPEC needs to cut at least one million barrels per day from its present ceiling of 24.5 million barrel per day if it wants to boost the sagging oil prices. Non-OPEC oil producers have little flexibility to cut output.

Oil prices fell below US\$ 15 (brent crude) a barrel, the lowest level for three years, as OPEC failed to keep production in line with demand. In real terms, the crude prices are now lower than the prices prevailing in 1972. The major problem is how to accommodate the strong rise in Kuwaiti oil production. Kuwait refused to accept the quota set at the June OPEC meeting and has continued to raise its production. A further bearish factor for the oil market is the re-entry of Iraq in about six months' time as it has reached an agreement with the UN about permanent inspection of its arms site.

6.4 Domestic Rainfall

The long-term average rainfall in 1993 has been 101 per cent. This was the sixth normal rainfall in a row. The late rains in September and October bode well for agricultural sector growth during Rabi season.

7. Output

Official reports have started mentioning that in 1992-93 the growth rate was 3 per cent and is expected to be 4.5 per cent in 1993-94, which we predicted last year. World Bank estimates that growth in agriculture sector this year would be around 4 per cent and 3.5 per cent in manufacturing sector. Assuming favourable monsoons, better growth performance is expected in fiscal year 1994 but India faces a challenging task in managing India's balance of payments, according to the World Bank's "Trends in developing economies".

7.1 Agricultural Output

The post-monsoon showers have raised the hopes of a bumper rabi harvest. A good harvest of oilseeds and cash crops would boost economic growth and keep price rise under control. Agricultural production prospects in 1993-94 are very bright. The kharif foodgrains production is estimated to be around 103 million tonnes. The target for Rabi food crop is 82 million tonnes. Rabi crop is going to benefit from the late season rain. The rabi foodgrain crop is expected to be 82 million tonnes as against 78 million tonnes in 1992-93.

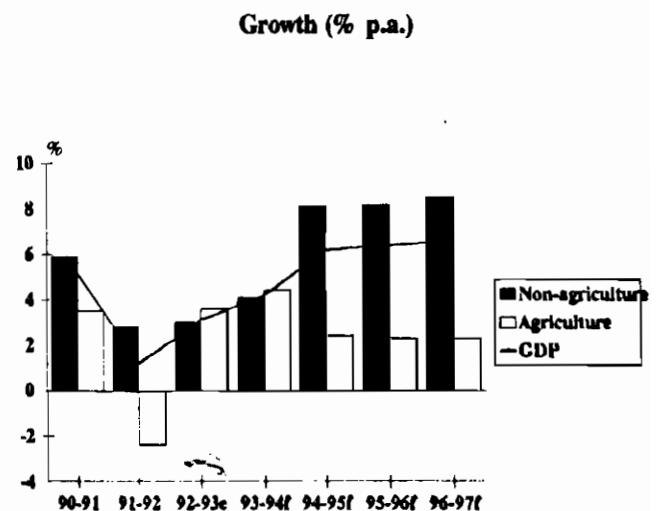
The country is expected to record a harvest of 185 million tonnes of foodgrains in 1993-94. A bumper Oilseed crop is expected. Another bumper cotton crop of 13.5 million bales is expected this year. But, this is marginally lower than the last year's record output of 13.6 million bales.

The minimum support price (MSP) for rabi crops for 1993-94 has been increased by six to seven per cent. Compared to 20 per cent increase given for the kharif crop, this increase is minimal. For Rabi, the MSP for wheat is Rs.350 per quintal which is Rs.20

more than last year's and represents an increase of 6.1 per cent. Subsidies on fertilisers which were expected to be taken away before Rabi season was the reason to increase MSP for Kharif by 20 per cent. The subsidies have not been removed for 'political reasons' and voters are paying it as 'inflation-tax' now.

There has been a spurt in consumption of decontrolled fertilisers in the second half of the 1993 kharif season. However, consumption of Di-Ammonia Phosphate (DAP) and Mono Phosphate (MOP) is still below 1992 consumption level.

The overall growth of the economy in the recent period has been mainly on account of a strong agricultural performance. But, fall in investments in agriculture in the eighties has affected the long-term growth of the sector. The draft agriculture policy, introduced in Parliament in early 1993, the modifications in the trade policy in April 1993 and the hike in procurement prices of foodgrains are all directed at the growth in agricultural production. Foodgrain stocks are in a very comfortable position this year. Compared to 11.8 million tonnes in September 1992 it is



23.8 million tonnes this year. Given such a comfortable position and with emphasis on exports, the Commerce Ministry abolished the minimum export price on superior variety of foodgrains such as Durum wheat. With a major shift in trade policy, agricultural exports are set to boom this year.

7.2 Non-Agricultural Output

Is Indian industry still in recession? The CII survey done in October shows that machine tools, construction equipments, oil and gas services, ferro alloys are still short of orders but textile machinery has started looking up and cement is showing a turnaround. This is corroborated by NCAER business expectations survey of October 1993 which suggests that capacity utilisation has improved in the third quarter of 1993.

Despite a pick-up in agricultural income, the index of industrial production in the first quarter of the present financial year shows a decline in output over the corresponding period of the previous period. In May only the industrial production showed a marginal increase. The sectoral breakdown of the industrial sector, infrastructure sector showed a growth of 8 per cent in the first four months of 1993-94, the mining sector index dipped by 5.8 per cent during the same period and manufacturing sector posted a poor figure of -0.4 per cent in this period. On the positive side, industry groups such as textile products, jute, beverages and rubber products averaged double digit growth rates in the first six months of 1993-94. Manufacturing companies are expecting increased demand for their products now. One of the reasons for capital goods industry's recession is that import of finished goods attract much lower tariff compared to the intermediates and raw materials. Bearings, chemical based industries, fertilisers etc. are all being affected due to lowering of the tariffs and it is hurting them. If the duties are based on the theory of zero protection at factor cost, then the industry can compete with the imports.

The CSO is aware of the fact that the official industrial index is way out of line with current realities. It is deficient because it does not adequately capture the contribution of the small scale segments of Indian industries and the unorganised sector in general. Green sprouts of recovery are clearly visible in the industrial production statistics of August 1993. September figures for automobile sector, saleable steel and jute goods are also encouraging. The growth in power generation is healthy. In the first five months of 1993-94 electricity generation grew by 9.3 per cent on average and in August alone the growth was as high as 13.3 per cent.

8. Interest Rates and Credit

The busy season credit policy has dispelled the doubt that the RBI is going slow on financial sector reforms. In line with the Narsimhan Committee recommendations, statutory liquidity ratio (SLR) on domestic net demand and time liabilities is reduced by 2.5 per cent from 37.25 per cent to 34.75 per cent. The incremental SLR is reduced by 5 per cent from 30 per cent to 25 per cent. This is expected to augment the lendable resources of banks by Rs.4,500 crore. The favourable busy season credit policy announced by the RBI in mid-October has not helped banks in raising sagging bottom line of their balance sheet. It is widely believed that only

increase in capital expenditure by the government can spur demand. Banks have as much as Rs. 10,000 crore but as they are interested in cleaning up their balance sheets of bad assets and the government is continuing to mop up excess bank liquidity, industry starved of funds could take some time to ease off.

The new lending norms have not been given unalloyed welcome by all the bankers. So far, they had worked interpreting and following circulars. With new freedom they do not know how to make use of it. Coupled with capital adequacy ratio and provisioning norms which they have to follow now, they are very cautious. One hopes that this hesitancy disappears quickly and as they gain experience, the credit is made available to industry and business. It has been reported that profitability of the banks according to the half yearly results upto September 30 is under pressure. After allowing the provisional norms for remaining non-performing assets, many banks which were in black this year may end up showing losses in 1993-94. The 12 banks which showed losses in 1992-93 continue to remain in red in 1993-94 partly because of provisioning norms.

Why is it that there are no takers of credit under the liberalised credit policy? Banks are flushed with funds and they do not know whom to lend? With the reduction in statutory liquidity ratio announced by the RBI in October, the liquidity has gone up tremendously but there is no demand for these loanable funds. Nay, there is no demand for the funds at the rates of interest the banks are ready to give loans to the corporate sector. Hence, there is a demand for loans at floating interest rate. But, to lend funds at a floating rate, market needs a reference rate and we do not have one. It has been argued by some economists that though India has achieved macroeconomic stability i.e. compared to eighties deficit low fiscal deficit and stable inflation rate, the banking sector beset with about 22 per cent non-performing loans is not ripe for interest rate deregulation. Otherwise, there would be a scramble for deposits and competition to lend to risky borrowers. This would squeeze profit margins and the banking system would be adversely affected. Given the fact that capital adequacy norms are already making the bankers risk averse would they go for risky borrowers? The deregulation in the financial sector has created log-jam in the money market. The only way it can be solved now is by deregulating interest rates further and allowing term-structure to develop which would reduce the interest rate and tenure mismatch as it exists now. In fact, as banks have been allowed to operate in futures and options of foreign exchange (from January 1994), they would be able to innovate products better if they know domestic term-structure of interest rates.

No enterprise, in the given disinflationary environment would borrow long-term funds from banks at prevailing rates. Invariably, interest rate on long-term government securities provide the reference rate. These rates at present are much higher than the prevailing inter-bank rate and hence do not reflect liquidity position of the market. Unless the reserve requirement on call money is removed, banks are unlikely to borrow in the call money for more than fourteen days - reporting period of SLR and CRR for banks. Most likely, the reserve requirement on incremental call money would be reduced to bring about inter-bank call money market for longer periods. The 'short-term' inter-bank rates would reflect the true cost of fund to financial institutions and provide reference rate for the floating interest rate. Interest rates in the domestic market are way above those prevalent abroad and a reduction in these is necessary. It is almost certain that interest rates have to be freed by RBI. This is the reason why Morgan Stanley

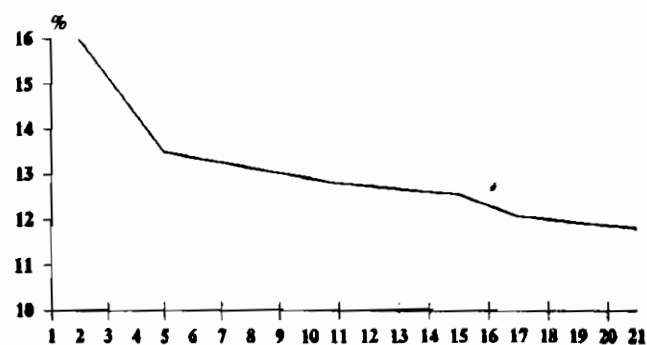
forecasts a disinflationary phase in Indian economy and expects interest rates to come down to 11 per cent level.

Credit cannot be forced down on an unwilling investors. Bankers worried about prudential norms, the attractive gilt rates and zero risk on government securities to fall back upon, would not stick their neck out. If both, the borrowers and lenders, do not get out of this vicious circle without delay, the new credit policy would be a good beginning but a non-starter as far as recovery in industrial investment is concerned.

Between April and mid-November aggregate deposits have increased by 9%, bank credit to commercial sector has increased by 3% even though food credit leap frogged by 30% but investments have gone up by 13%. High yield, SLR requirement and the 'zero-risk' on government loans are responsible for the overwhelming demand for both treasury bills and dated securities. The compulsion to create risk-free asset portfolio has channelled the excess liquidity in the banking system to absorb sovereign debt instruments. A situation exists, at present,

where banks find it attractive to invest in government paper rather than extend credit to industry. In a way, centre's high borrowing requirement has been a 'godsend' gift for many bankers. In this way, government is bailing out the financial sector and bringing down reliance on RBI credit. This fatal attraction can be expensive in the medium term. Interest payments are expected to constitute about 30 per cent of the centre's total budget expenditure for 1993-94. It may rise to about 40 per cent by the end of this century. With spurt in growth the dependence of government on borrowings is likely to disappear. This would force the long-term interest rates to fall by 2% in the coming six months.

Yield of Govt. of India Securities (% p.a.)



9. Inflation

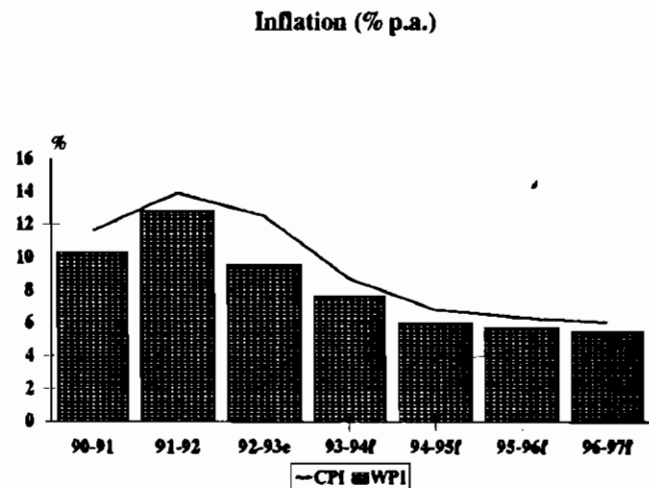
As expected, in spite of good kharif output, food prices have gone up because the minimum support price for agricultural commodities was raised. The minimum support prices act as floor price for the market. Increase in the administered prices contributed significantly to the rise in WPI in spite of the dampening effect which agricultural supply-side factors provided to the economy. Furthermore, the inflationary expectations have been a result of a huge surge in liquidity on account of higher budget deficit.

A complacency in the control of inflationary pressure could worsen the situation during the remaining period of 1993-94, even though keeping prices under control is necessary to keep the reform programme going. Any further increase in inflation may derail the plan to lower interest

rates further. With industry still not ready to borrow, the investment demand may get nipped in the bud. Hence, a rein on fiscal profligacy even in the remaining months of fiscal year 1993-94 should be given top priority. An increase in industrial activity could give buoyancy to revenue from excise tax and corporate tax which may act as automatic stabiliser.

While total money supply (M3) increased by 13.4 per cent by November 12, 1993 from a year earlier, RBI credits to the central government increased only by 8 per cent, in spite of the fact that fiscal deficit is expected to be increased by 1 per cent from the budgeted figure of 4.7 per cent. The main reason for this apparent anomaly is that the central government is relying more on market borrowing and money supply is increasing due to spurt in net foreign exchange assets of the banking sector as a result of exports growth and successful euro-issues.

It is widely feared that inflation rising at a rate of 8 per cent or so may send the liberalisation process into a tail-spin. Many believe that the future of Congress party in two years time lies in controlling the price rise, otherwise, voters, as they have done in the past, would like to give a chance to a party which promises to bring prices under control. However, much before that the foreign investor may show thumbs down to the government with perilous results.



10. Exchange Rate

Rupee has gained against most of the European currencies since March 1993. The huge purchases made by the RBI helped to ensure stability in the exchange rate of the rupee. If RBI continues to follow a policy of providing lower ceiling to rupee-\$ exchange rate, it is expected that rupee would appreciate against European currencies as US\$ is expected to appreciate 3% in 1994 as the US economy continues to be on a sluggish recovery path.

One of the strong reasons to convert rupee on capital account is that through the havala market it has been convertible anyway for big fish and non-convertibility has been irritant to small fish and a hindrance in foreign travelling etc. In havala market the premium has been less than 5 per cent for a long time: One can expect that rupee would not depreciate if it is made convertible on current account now and on capital account by the end of 1994. Additionally, it would send a clear signal to overseas investors that reforms are on course and here to stay, come what may. It would attract far more money than is flowing out from here. The forward premia has been stable after the Finance Minister's statement on convertibility of rupee, which indicates that a devaluation either by the RBI by raising dollar buying rate or due to convertibility is unlikely.

The rupee convertibility does not mean that Indian markets would be flooded with foreign consumer goods, cars, televisions etc. The restrictions in the form of tariffs and low disposable income would ensure that such a situation does not arise. The experience of neighbouring

countries - Pakistan, Nepal and Sri Lanka - which have made their currencies convertible suggests that domestic producers come under an intense competition to produce quality goods at competitive prices and balance of payment position is not much different from earlier times.

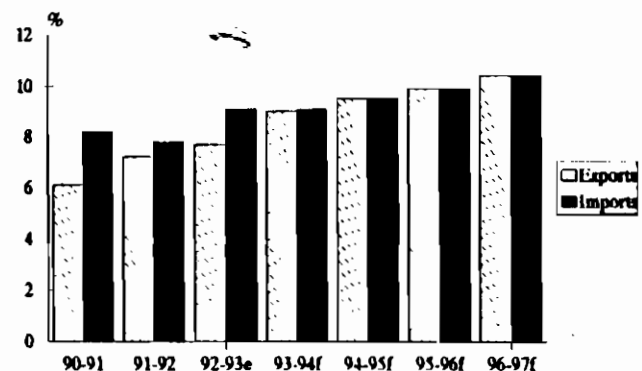
11. Trade Balance

Exporters have become blue-eyed boys as Indian development strategy is taking a volte-face from import substitution to export promotion to develop the economy. The exporters have to be extended all the help they need as exports are an overriding national priority and its promotion and facilitation is taken to be a collective responsibility of the entire government. It is almost 180 degree about turn from the days of FERA. To make sure that states also promote exports, the central government is going to provide them incentives. To make sure the message passes down the line to middle level bureaucracy, the central government has threatened to take disciplinary action against its employees who are seen to cause unnecessary delays. It is not important what the government says but it is important what it does. In that respect eliminating or reducing procedural delays is quite helpful. For example, granting of green channel status to trading houses and export houses would go a long way in increasing exports. Working on the basis of trust rather than suspicion all the time, would provide non-monetary incentive to exporters. The changes in working practices, like round the clock working by customs officials at all national and international entry and exit points would further bring down hidden costs. Therefore, the Federation of Indian Export Organisation has welcomed these bureaucratic changes and they reckon it would boost the morale of the exporting community, smooth export promotions and expand exports from India.

Imports have shown negative growth in the first seven months of this year and even if there is a spurt in imports, the level of imports would not be much higher than that of last year. Given that the exports are growing by 20 per cent in dollar terms this year, trade balance is likely to be in equilibrium. This year from April to October the total exports were US\$ 12.13 billion and imports were only US\$ 12.70 billion. In percentage terms imports declined by 1% over April to October imports of 1992. There are two easy

explanations for it. One is that crude oil prices have fallen sharply and India has got a windfall gain from this. Second, the industries which are import intensive are in recession and hence imports have not picked up. The last argument is rather weak as the automobile sector and consumer electronics which are import intensive are no more in recession. The company results of these sectors show that production, sales and profits have increased. If that is so, why have the total imports not risen? Well, there is no data to show it empirically but the probable reasons are as follows. First, the public sector investment has almost come to a naught and it was this

Exports & Imports (% GDP)



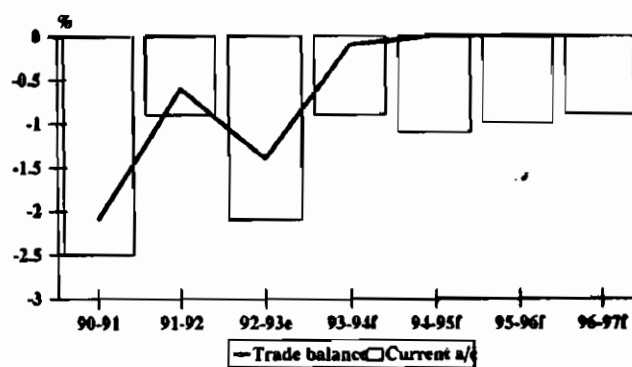
sector which was the most import intensive. Second, the rupee devaluation has made imports expensive even after taking into account the reduced tariffs and hence domestic substitutes are being used. Third, the domestic competition is forcing the domestic producers to cut costs and explore the possibilities of substituting domestic products for costly imports. Hence, the liberalisation is making inroads in the high cost economy and trying to reduce high cost in a short span of two years. This bode well for the industry and economy in the long-run even when higher industrial growth takes place in near future. The external sector imbalance would achieve equilibrium or get in surplus sooner than many economists expect it to happen.

One needs to be a little cautious about import data in the coming months as only after October bunching of imports takes place. Bulk imports such as those of petroleum products, crude oil and fertilisers are undertaken in the last quarter of a calendar year. Notwithstanding this, trade bodies like the Federation of Indian Export Organisation (FIEO) is confident of maintaining an average growth rate of 25 per cent in exports for the next two years, thus not only breaking even in trade deficit but graduating towards an export surplus era.

They are confident to achieve the target of US\$ 22 billion in 1993-94 which is about 20 per cent higher than the last year's exports of US\$ 18.4 billion in value terms. The Finance Minister on his part has assured the exporters of progressively improving their profitability through a series of measures including macro-economic policies and exchange rate mechanism. Thanks to buoyant exports, the country boasts of a satisfactory level of foreign exchange reserves.

On capital account, money would continue to flow in as investors perceive political stability, foreign brokers are allowed to operate on behalf of foreign institutional investors and the markets are opened up. All fund managers need to have some exposure to new emerging markets. Not only that, as spelt out earlier, attractiveness of long-term capital appreciation and wide range of equities, though small in quantity by international standards, is making Indian market very attractive to fund managers. The Euro-issues are being oversubscribed as India's specific funds need to have a corpus fund which can easily be acquired through Euro-issues. Allowing foreign brokers to operate in the Indian stock markets on behalf of foreign institutional investors would further help in attracting foreign portfolio investment. It is estimated that as much as US\$ 500 million per month may flow in the next few months apart from US\$ 1 billion expected through Euro-issue of Videsh Sanchar Nigam Limited which is expected to be completed before March 1993.

Trade Balance & Current a/c (% GDP)



12. Public Finance

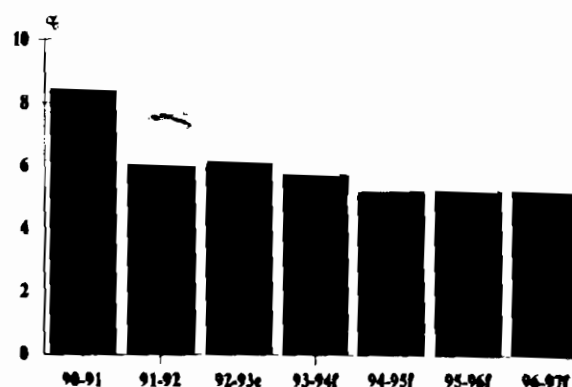
The recently published status report on the external debt asserted that government is keeping a close watch on the external debt situation to keep it within prudent limits. India is not expected to accumulate short-term debt to maintain forex reserves and short-term debts which are not covered under trade related credits upto 6 months would be reviewed by a High Level Committee on Debt Management. As a result of 42 per cent concessional debt, the present value of Debt-Service-GNP ratio is 23 per cent compared to External Debt-GNP ratio of 29 per cent according to the World Bank's World Debt Table 1992-93. The present value concept takes the term structure and concessionality mix of debt rather than nominal value of debt which is used in the External Debt-GNP ratio.

The large proportion of external debt in the form of concessional debt is reflected in significantly lower rate of interest on overall external debt. India pays only 5.8 per cent on her external obligations compared with Indonesia's 6.1 per cent or Mexico's 8.2 per cent. The proportion of short-term debt is only 7 per cent in case of India whereas it is 18 per cent in Indonesia and 25 per cent in South Korea. It seems that this is a short-sighted policy as short-term rates are much lower than long-term rates. It would benefit India to move from long-term to short-term debt. However, what is overlooked by analysts is that volatility of short-term rates is higher than the long-term rates. The short-term rates are expected to move up next year and given India's rating at present, India would have to pay the risk premium of 2% above the LIBOR rate on its short term obligation. In any case, as imports pick up short-term debt as a percentage of total debt would also expand. Being trade related debt it would be of self liquidating in nature.

The external financing gap which was estimated to be US\$ 1.8 billion has declined substantially in the first six months of the fiscal year 1993-94. Hence, India may decide to forego a part of US\$ 2.2 billion fast-disbursing loan which was pledged to her in the Aid-India Consortium. India has already received US\$ 300 million loan under stand by agreement of IMF. Given better than expected reserves position which is estimated to be US\$ 10 billion by the end of 1993-94 fiscal year, India has postponed hold talks with the IMF for an EFF loan but sectoral loans from the World Bank for financial sector have been concluded satisfactorily. Sectoral loans from the World Bank linked to reforms in public sector, hydrocarbon sector and agriculture are in the pipeline.

Over the next four years, India will need to repay about one-third of its US\$ 76 billion external debt as of March 1993. Financing the current account deficit and debt repayments will require about US\$ 8 billion of gross inflows in fiscal 1994 and about US\$ 10 billion a year in the

Central Government Fiscal Deficit (% GDP)



subsequent three years. With the surge in foreign capital it seems that there would not be any difficulty in meeting these obligations.

How did the government manage to meet quarter-end fiscal deficit in 1992-93? The Finance Ministry officials say that it was "Geethakrishnan effect". Mr Geethakrishnan was the Finance Secretary and also in charge of the revenue department in 1992. To put it bluntly, the books were cooked as additional tax was collected from the public sector companies as self assessment tax before June 30, 1992 because of verbal direction from the Finance Secretary. The gross income tax and corporation tax during the April-September 1993 was around Rs.8,500 crore but the net collection was only Rs.6,000 crore as Rs.2,500 crore refund had to be made. The refunds were almost double the 1991-92 year's refund figures.

The budget deficit at present is running at the level of Rs.13,000 crore. The budget estimate of Rs.4,314 crore for 1993-94 was based on the assumption of fiscal deficit being brought down to 4.7 per cent of GDP. No one believes that it can be achieved. However, the new estimate made by the Ministry for budget deficit, on the basis of fiscal deficit of around 5.7 per cent of GDP, is Rs.11,000 crore. The reasons given for a fall in budget deficit by Rs.8,000 crore are collection of taxes, other payments and issue of treasury bills. The central government has borrowed 25 to 30 per cent of its requirements in the current financial year through auctions of treasury bills at market-related rates, thereby reducing its borrowings through the issue of ad hoc treasury bills considerably.

Excise collections in the month of October were higher than its target figure. The collections in the first six months were short by about Rs.1200 crore - roughly 7 per cent short from their target figure. Customs duty also showed a fall of about 18.5 per cent in the first half of this year and the trend continued in the month of October: an indication that imports in value terms have not picked up. The shortfall in custom and excise duties so far is of the order of Rs.4000 crore. As there are signs of revival in industrial production, the tax revenues shortfall may be around Rs.4000 crore. It is expected that the part of loss in revenue would be made up by an increase in imports in later half. Revenue collections from income tax including corporation tax showed a decrease of about Rs.60 crore in September 1993 compared with September 1992 collections.

Therefore, figures of direct tax collections after taking into account "Geethakrishnan effect" are credible. The excise taxes should pick up as industrial activity improves and custom duty, of course, would start looking up as capital goods demand and other raw materials etc. are imported in a more liberalised economic environment. In short, the external debt position is quite reasonable but domestic debt is rising. In particular, high real interest rates on debt imply that in future, during the downturn of economic cycle, government would find difficult to rely on deficit and debt finance. The arithmetic of debt accumulation with low growth and high real bond rates would scuttle present investment in productive capital and may hamper long-term growth. The domestic debt being financed through bonds seems to suggest a debt way of funding domestic debt but because of high domestic interest rates the government is mortgaging the future growth.

13. Investment

Indian economy is on the move and many investment opportunities are becoming available and many companies are now looking at India to do business here. Apart from the fact that long term interest rates are high, one other reason why entrepreneurs are shying away from investment is that they know that the excise duties and import duties are going to be cut next year and cost of funds would reduce further, hence they are not interested in investing in capital goods today. Investment demand, therefore, dried up not only in public sector, who are short of funds but in private sector too, who see it as an expensive proposition today.

There are indications that industrial production is picking up and with it imports would also pick up. The Finance Minister is in an upbeat mood and hopes that foreign direct investment of the order of US\$ 5-7 billion by mid-nineties is possible. The fiscal reforms brought about in the coming budget would give a clear picture whether his hopes would materialise or not. The economic growth would be main beneficiary and FDI would be just top dressing.

14. Consumption

While the agriculture and exports have posted healthy growth rates during the current financial year, industry is also coming out of the woods. The recovery in the industrial production is mainly due to consumer demands. The fiscal relaxation and smart pick up in incomes in rural areas, augur well for a growth in industrial production and consumption in coming months. The increase in government fiscal deficit of the order of Rs. 7000 crore has gone in consumption in the third quarter of 1993-94. The consumption would be further helped by the onset of marriage season now.

15. Labour

Bank unions have seen the light of the day and called off the much publicised strike from November 2 as they realised that with 12 of the nationalised banks in red and banking industry, showing signs of creaking. The banks are in no position to accede to the union's main demand of granting pension as a third benefit. The banks reeling under the impact of provisioning and capital adequacy norms, could not have met the obligations of pension. It is also evident that industry-wise negotiations will have to be given up.

A study carried out by All India Management Association suggests that the pressure of competitive forces are forcing companies to close down their unviable operations and restructuring their businesses. Labour is cooperating in the process of restructuring whether it is done by closure or by trimming the labour force. In case labour does not cooperate and go into litigation, the business is just closed down and labour does not get its due share. Unions have to realise the new reality. If they don't, it is more than likely that they would be by-passed by their members to settle directly with the employers. Thus, all concerned parties are realising that an

exit policy is almost essential - without it Indian industry would not be able to restructure itself and hence can never compete with the foreign companies. But, bureaucracy is still dragging its feet in letting a safety net to emerge for the transition period.

The Finance Minister has been saying all along that a medium term safety net for the structural programme is required as it is not only good politics but good economics too. The NRF is supposed to provide safety net and readjustment cost to public sector and private sector alike. On the labour front, the National Renewal Fund (NRF) has run into bureaucratic tangle. Originally it was planned that the inter-ministerial empowered Committee would screen the schemes and allocate money. But the power to allocate funds, for the time being, rests with the Expenditure Finance Committee (EFC). As the empowered Committee is not a statutory body, money for all the schemes has to be sanctioned by the Parliament. Mr Sanat Mehta, a member of the empowered committee, threatened to resign from the committee; that has brought the issue into sharp focus and most probably some decisions would be taken soon to resolve it.

Many companies like MMTC, State Trading Corporation, Bharat Gold Mine Ltd, Hindustan Shipyard Limited - have successfully implemented Voluntary Retirement Scheme (VRS) and have reduced their workforce. Funds have been provided from the National Renewal Fund. But they do not call it a retrenchment scheme. Even BIFR is taking a stern view towards excess manpower in public sector units. The private sector's quota of NRF withdrawals is going to be restricted to 15 days salary per year worked as per the statutory requirements rather than a full package of lay-off benefits which includes the provident fund sum, gratuity, accumulated earned leave dues, retrenchment benefits and ex-gratia amount of VRS of 30 days per year worked.

The NRF is under a close scrutiny as the Labour Ministry has warned that it will not cooperate on the matter of industrial restructuring unless retraining/redeployment plans under NRF are emphasised. The industrial restructuring is at the hub of the proposed New Industrial Relations Bill to be placed before the winter session of Parliament. This year NRF has budgeting allocation of Rs.1,020 crore, which includes only Rs.50 crore for retraining and redeployment. The question of Empowered Authority's powers vis-a-vis the Finance Ministry's rule book has come in the way of retraining/redeployment as well as the provision of a "safety net".

The 'Ahmedabad Project' is a novel scheme in the restructuring of rundown industries. It is essentially an agreement between trade unions, managements and state governments on closing unviable units and paying compensation to workers. Many of these units have been closed for some time already and workers do not get any money from these companies. To rejuvenate the economy further and utilise the labour, the project envisages training laid off workers so that they become self employed or gain employment elsewhere. This is the 'caring' side of the reform programme. However, the Finance Ministry officials have been dragging their feet and not sanctioning money for this project as the Empowered Authority of the National Renewal Fund is not a statutory body and hence all the projects have been awaiting clearance from the Prime Minister's office now.

16. Conclusion

Almost all economists including critics agree that two and a half years ago nobody could have imagined that the restructuring process could go as far as it has now. The recent economic indicators like stable supply, controlled inflation, narrowing trade deficit and comfortable forex reserves show a sustained economic recovery. Not only long term investors but short-term investors are also lured by the underlying economic strength. According to Fortune, India is one of the five hot markets around. The global and international investors can expect to get 30 to 50 per cent returns in 1994.

Cynics have been proved wrong about the outcome of restructuring process. No doubt, a good rainfall in the past two years has helped in maintaining a positive growth rate and getting control over inflation. Buoyant growth in exports and better than expected foreign reserves have been a direct result of economic policies. This has been underlined by comparatively good growth in foreign direct investment and interest shown by foreign institutional investors in Indian capital market. The forthcoming budget as a statement of government intent and taxation is expected to liberalise the economy further. In all probability the rabbit the Finance Minister produces in his 1994-95 budget would be live and not just shaken to make it appear live.

Both national and international, industrial and financial institutions are waiting for labour policy reform. Only after that inflow of investment and speeding up of industrial activity would take place. The government proposes to introduce amendments to the Industrial Disputes Act in the winter session of the Parliament. The 'Ahmedabad Project', which envisages closure of unviable units and sale of assets of textile mills under liquidation to provide compensation to workers. The pioneering work this project wants to undertake is that it wishes to extend finance for retraining and entrepreneurial development to retrenched workers.

The strength of Indian economy lies in resilience and entrepreneurial spirit of the population. The forthcoming budget is awaited to unleash this force. One should not expect it to do the unthinkable but it would be a step forward towards economic development which would lead to a prosperous and a vibrant Indian economy.

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