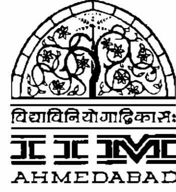

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INDIAN ECONOMIC FORECAST
AUGUST 1992

By

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Indian Economic Forecast: August 1992

by

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ABSTRACT

On the eve of the present government's anniversary of assuming office, pessimism towards stabilisation and reforms were well entrenched in the media. With the help of hindsight one may opine that it was the loss of political grip and later certain irregularities in the money market which snowballed into a fraud and resulted in a pessimistic perception. Further meteorological forecast about monsoon precipitated the view that the economy is going to face stagflation. No one expects output to fall this year. The economy has grown in the first quarter of the fiscal year 1992-93, albeit slowly. Economic activity is expected to accelerate in the next few months. Inflation is under control and set to average just under 10% for the year 1992-93; the central government fiscal indiscipline is almost under control and there are good indications that the *kharif* and the *rabi* crops may turn out to be bumper crops. But that is not enough for rapid sustainable growth of the economy.

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1. Overview

No one expects output to fall this year. The economy has grown in the first quarter of the fiscal year 1992-93, albeit slowly. Economic activity is expected to accelerate in the next few months. Inflation is under control and set to average just under 10% for the year 1992-93; the central government fiscal indiscipline is almost under control and *kharif* production is likely to achieve its target. There are good indications that the *kharif* and the *rabi* crops may turn out to be bumper crops. But that is not enough for rapid sustainable growth of the economy. Government should not ignore the link between credit and economic growth even in transition period. Informal rationing of credit by bankers may scuttle any long-term gains which India had from the last year's stabilisation and liberalisation process. Removing the uncertainties for private sector investment and motivating top managers of the banking sector to lend a supporting hand in encouraging trade and investment is in the hands of the government. Failing to do so economy would post halting growth this year.

The government has implemented the Joint Parliamentary Committee recommendations on fertiliser subsidies and has made public the Chelliah Committee report on tax reforms. A substantial part of it is likely to be implemented in the 1993-94 budget. The changes in corporate taxes and excise taxes, as suggested in the report, would augment the supply side of the economy in the medium term. The economic reforms may get a shot in the arm in September 1992, just before the bi-annual meeting of Governors of the Fund and the Bank to keep the momentum of reforms going.

2. Forecast

The present forecast (table 1 and table 2) has been updated on the basis of new information available about the implementation of conditionalities of stabilisation programme and its effects on key factors - the fiscal deficit, balance-of-payment and inflation - in the fiscal year 1991-92. We have also taken into account the monsoon data available so far and the expected *kharif* crop output.

3. Exogenous variables

3.1 World Interest Rates

There has been a slight movement in the short-term interest rates in the last quarter in the U.S. and Japan to boost the sagging domestic economy. On the other hand, fear of inflation has led German interest rates to edge slightly upward. Altogether, there is not much significant change in the average of the short-term and the long-term world interest rates. Doubts about Maastricht Treaty is upsetting the markets and due to the economic slow down, a yes vote in France on September 20, 1992 is not being seen as a foregone conclusion. If the French referendum vote on 20th September is positive on Maastricht Treaty, the risk of devaluation among the weaker currencies within EMS would ease. Subsequently, the interest rate differential between Germany and its European partners would then narrow.

3.2 World Trade

World trade has suffered further as the economic upturn, supposed to have taken place in the second quarter, has not materialised. The US economy has seen faltering growth in its economic activity in the second quarter. Expectations are that the growth will pick-up in the second half of 1992, but sluggishly, as the elections draw nearer and political uncertainties start to worry the markets. Japan too is unlikely to achieve its target of 4% growth in 1992. Germany has also not recovered from its domestic inflation.

Table 1: Exogenous Variables

	1990	1991	1992	1993	1994	1995
World						
Trade growth (%)	4.0	1.5	2.0	6.0	5.9	5.5
Real Short-term Interest Rate	4.0	4.1	3.7	3.8	3.8	4.2
Real Long-term Interest Rate	5.7	5.4	5.0	4.6	4.1	4.4
O.E.C.D. Inflation	4.5	4.3	3.4	3.0	2.9	2.9
Crude Oil($/barrel)	18.0	20.0	18.0	18.0	19.0	19.0
Domestic						
	90-91	91-92	92-93	93-94	94-95	95-96
Rainfall * (% of normal rainfall)	106	92	100	100	100	100

Table 2: Forecast

	90-91	91-92	92-93	93-94	94-95	95-96
GDP growth (%)	5.6	1.6	3.0	4.0	6.0	6.0
WPI (%)	12.1	12.8	9.5	7.0	6.5	6.0
CPI (%)	13.6	13.9	10.0	7.0	7.0	6.5
Expo (%GDP)	6.2	7.2	7.5	7.9	8.2	8.3
Imports (%GDP)	8.2	7.8	8.5	8.7	9.0	9.0
Current a/c (%GDP)	-2.5	-1.0	-2.3	-2.1	-1.7	-1.5
Current a/c ($ bill)	-9.9	-3.0	-5.3	-4.0	-3.0	-3.0
Capital a/c ($ bill) (principal repayment)	-3.0	-3.0	-3.3	-4.0	-4.5	-5.0
Exchange Rate (Rs/$) (open market, nominal)	18.2	24.5	32.0	33.5	35.8	37.6
Production (growth p.a.):						
Agriculture	3.2	-1.0	3.0	2.1	2.2	2.2
Non-agriculture	7.0	2.8	3.0	5.0	8.0	8.0
Investment (% gdp):						
Private Sector	14.0	12.0	13.2	14.7	15.5	15.2
Public Sector	10.5	9.5	9.0	8.7	8.4	8.4
Govt. expdt. (%gdp) (Central + State + UTs)	32.0	30.5	30.0	29.7	29.6	29.5
Central govt. deficit (%gdp)	9.0	6.3	5.0	4.0	4.0	4.0

Given this scenario of large industrialised economies, the overall growth in the world trade is not expected to grow more than 2% this year and hopes are that in 1993 world trade growth would pick up to 6%. From 1994 onwards world trade growth is expected to grow at its historical long-run average of around 5.5%.

3.3 Oil Prices

As expected, the oil ministers of OPEC countries, in May 1992, increased the quota for Kuwait by 200,000 barrels per day and kept the quotas for other countries same. Their hopes of oil prices to perk up and hit the ceiling of $21 per barrel is unlikely to materialise as world-wide recession is going on. Only in winter there may be a slight increase in demand due to seasonal factors. In the event of actual military operation by the U.S. in Iraq to nullify offensive weapons technology may see spot prices of crude oil to shoot up temporarily; but chances of such an eventuality are remote. Oil prices which have moved up to just $20 a barrel may be hard hit when Iraq decides to abide by UN conditions for lifting sanctions and Iraqi crude productions have to be incorporated in OPEC countries production.

3.4 Domestic Rainfall

The South-West monsoon is almost normal. As predicted by the Meteorological Department the monsoon was late by one week but the total precipitation has been normal and if it follows the 1983 pattern of rain the total rainfall may be more than its long run average. Even spatial and temporal distribution is better than expected in most of the regions which depend on monsoon for agricultural production.

4. Output

Good rainfall has averted the danger of stagflation this year and agricultural sector is likely to meet its target. The overall economic growth, however, is predicted to grow around 3% only. This growth rate is pessimistic compared with the projected growth rate announced by the Finance Minister in his budget speech. Given the industrial production in the first quarter of the fiscal year 1992-93, even 3% increase in real gross domestic product in the midst of stabilisation programme should not be considered unfavourable. A marginal upward revision in the forecast is due to downward revision of 1991-92 growth figure and expected bumper agricultural growth this year.

4.1 Agricultural Output

As noted earlier, the nearly normal rainfall has brightened the prospects of *kharif* production. In 1991-92, *kharif* foodgrain production was approximately 96 million tonnes; roughly 4% below the target set for it. In 1992-93 the target is 103 million tonnes which is 7% higher than the achieved target in 1991-92. Compared with *rabi* crop *kharif* crop output is more dependent on the monsoon. *Rabi* foodgrain crop output this year is set at 77 million tonnes; as most of the *rabi* output comes from irrigated areas there is less uncertainty as far as *rabi* output is concerned. The only uncertainty is from two quarters. First, the increase in farm gate prices of potash and phosphatic fertilisers would force farmers to use these fertilisers economically. Expectations among the fertiliser traders is that in the *rabi* crop, consumption of the fertilisers may drop marginally, but farmers would get back to same consumption pattern , as long as price of agricultural produce is remunerative. Second, increase in all petroleum products is imminent. How much these prices would be increased and maintained would depend on the political exigencies. If the subsidies on these petroleum products are not to make a dent on the overall fiscal deficits, the increase has to be in the range of 20% to 25%. To ameliorate the burden of increased input prices on farmers, the government is going to announce the procurement prices of *rabi* crops which have been decided but have not been made public yet.

An unusual increase in the coarse grain prices last year, which are normally *kharif* crops, and consumed by poorer section of the society has alarmed some economists and commentators. The differential between coarse grain prices and wheat prices is unlikely to widen this year as farmers are switching over to cash crops and even to wheat itself whose yield and revenue per acre is much higher than coarse grains. In fact, analysis shows that the prices of wheat and rice swelled because people substituted wheat and rice for coarse grain last year. Therefore, prices of wheat and rice increased more than expected last year.

A bumper *kharif* output, especially of coarse grain, is almost certain and the market has already made a correction downward in its prices. The prices of Bajra crashed in the last weeks of August in Delhi *mandi*. Post *kharif* harvesting period is likely to see prices of these crops falling further marginally in nominal terms. Expectations in the farming community in Haryana, Punjab and Western U.P. are bullish. These areas have received more than satisfactory rainfall and, therefore, they are expecting a bumper *rabi* crop this year.

4.2 Non-Agricultural Output

Industrial production which was almost even last year has marked up a tardy growth rate of 0.6% in April and May. Industrial production includes production of infrastructure industries like electricity generation, petroleum product and mining, which have shown a growth rate of 4% in the first quarter of 1992-93. In spite of import liberalisation and industrial reforms, consumer durable goods' production is declining. There is a demand recession in most of these industries and is unlikely to pick up this year due to credit crunch. Furthermore, consumers' liquid assets are blocked in stocks and shares, and general pessimism in the market has kept consumers away from acquiring durable goods. This is an unexpected fall out on trade from the stock market crash. Inventories are building up and producers are cutting back on their production. The problem of trade is exacerbated by payment crisis, combined with the fact that consumers have overdrawn. Private sector consumers are worried by a combination of high rate of inflation and their low wealth level.

New found optimism in August and timely government measures like reduction in interest rates and increased demand from rural sector may give a boost to industrial production in the coming quarter. Nevertheless, total industrial production is unlikely to exceed 3% in 1992-93.

It was the service sector in 1992-93 which single-handedly showed a remarkable growth rate of 5.2% in 1991-92. Given its major constituent, namely financial and banking sector in a tail-spin, low morale and every one looking over his shoulder to protect his back, it is unlikely that financial and banking sector would grow at all in the next two quarters in real terms. The banking sector is in an uncommon situation now-a-days. It is flushed with funds but does not have 'qualified' borrowers. Economists are of the opinion that as the inflation comes down in the coming quarter and inflationary expectations take a hard knock this year, the central government would adjust the market rules and

interest rates accordingly. However, transport sector, computer software industry *et cetera* may notch up a positive growth and hence overall service sector is estimated to show a 3% growth rate.

5. Interest Rates

Under the structural reforms, financial sector is slated to undergo major reforms in the coming months and interest rates are going to be made pivotal for resource allocation. However, in the transition period there may exist some inconsistencies and opportunities for arbitrage for the players may be thrown up.

Busy season credit policy is going to be announced in October. It is expected that interest rates are going to be brought down before that. Real long-term interest rates in the range of 10% cannot attract private investment. It is true that no worthwhile project has been shelved for want of funds in India in the past, but a high real interest rate is a deterrence to long term investment. This does not hurt the government borrowing but the industrial sector which depends on bank finance for working capital; this level of real rates make a gaping hole in its balance sheet. Favourable condition exists to cut interest rate by at least one percentage point now and another one percentage point before the Budget. This would give some relief to recession hit industries. This may lead to a sustained buoyancy in the capital market, which in turn would help private sector companies to raise large resources from the capital market for their long-term investment.

The Reserve Bank of India is not convinced that interest rate should be cut as M3 money has already registered a growth of 7% by now and it is likely that the year end figures would be well above the target of 10.5%. Strangely, this is due to credit expansion of 12% in this fiscal year in nominal terms. But this is due to the fact that this year government depended far more on the banking sector to provide its financial needs than use money seigniorage as was the practice in the past. Net bank credit to the government increased by 7.7% in the current fiscal year by mid-July. The RBI fears that any cut in interest rate would further fuel the monetary growth. However, the RBI views seem to be in minority.

6. Inflation

Low inflation means faster economic growth. Business and industry will face a more stable environment with lower real and nominal interest rates and a greater incentive to take the long view. However, transition to a low inflation, especially where direct and indirect subsidies are being whittled away to reduce fiscal deficit, involves risk of inflation flaring up again. In spite of good

intentions, the government may find itself in a dilemma. The question here is that once stabilisation of the economy takes place, i.e. balance of payment and inflation are under control, should government try to reduce subsidies which would fan inflation again? The answer is that fiscal deficit financed by printing money in developing countries is an important contributor to high rate of inflation. Therefore, removal of subsidies to reduce fiscal deficit would reduce the underlying rate of inflation in the economy and the rate of inflation flared up by removing subsidies is a one time affair.

The increase in petroleum product prices by 20% to 25% and subsequent rise in rate of inflation must be seen as correction in the economy. A bumper foodgrain production this year must dampen inflationary expectations. However, as the input prices are going to be increased later this year, one must not expect the losses to be absorbed by farmers. Their only alternative is to pass on part of the increased cost to the consumers. Consequently, average rate of inflation (WPI) in the fiscal year 1992-93 is forecast to be just under 10% in spite of a sharp fall in rate of inflation in August 1992. Keeping in line with the government's stated aims to bring down the subsidies further, the rate of inflation (WPI) in 1993-94 would reduce to approximately 7%.

The Finance Minister has stated in a seminar on 'Indian Economy' organised by Confederation of Indian Industry in August 1992 that inflation rate would fall to 3% level within two years time. We are not that optimistic. Long-term average of inflation rate in India has been around 6% and given the supply side reforms the model predicts an inflation rate of around 6% in the medium term.

7. Exchange Rate

One of the victims of the slowing down in reforms in the last quarter had been the liberalised exchange rate mechanism (LERM). Instead of graduating towards a convertible exchange rate, at least on current account, which would have given more incentive to tradable sector of the economy and exporters, it has remained in a stand still position. However, bit by bit reforms at the margin like including all segments of tourist industry, aviation sector *et cetera* as deemed exports and proposal to drop the lock in period for overseas portfolio investment, India is moving very cautiously towards a convertible but managed exchange rate mechanism.

The nominal exchange rate with respect to the US $ is steady but given the differential between Indian inflation rate and the US inflation rate, real exchange rate has appreciated roughly by 5% in the past twelve months. But, against the basket of currencies the real exchange rate has depreciated marginally in the last twelve months.

Given this cautious approach we forecast average rupee to $ nominal rate in 1992-93 to be Rs 32 and in 1993-94 about Rs 33.5. The later figure is on the basis of continued present exchange rate policy.

8. Trade Balance

A rise in imports in the February to May period this year is seen as a sign of industrial production picking up and officials are encouraged by the large number of companies planning to focus more on exports. They see exports as a buffer between sluggish domestic demand and themselves. But with industrialised economies in prolonged recession there is much uncertainty over how strong the growth in export performance will be.

Projected growth in exports by the commerce ministry is rather optimistic. Easing of imports only would not help export promotions. Other disincentives like high tariffs and two-tiered exchange rate have to be removed to get rid of barriers to trade.

Even in 1991-92 the increase in exports to General Currency Area by 6.4% in dollar terms is good in the face of unfavourable external circumstance. However, it is significantly lower than the last few years' growth rate. In 1989-90 and 1990-91 export to this area grew by 14.7% and 10.8% respectively in dollar terms. Exports showing an increase of 9.9% in dollar term in June 1992 is encouraging but overall 0.4% growth in the exports in the first quarter is nothing to write home about.

Imports are expected to grow from July 1992 onwards and it is hoped that this shall give a fillip to industrial production.

9. Investment

Private Investment

The economy has been advancing in the last five quarters, albeit slowly. Few expect output to fall, but in a lackadaisical environment, economic statistics, especially on investment, is likely to be choppy. How many firms will have to shelve further expansion plans due to tight credit policy is difficult to know.

ASSOCHEM survey of investment intention of Indian businesses predicts good climate for investment. Those who are interested in further investment have preferred to raise their capital requirements from capital markets. This is also borne out from the new issues expected to come in the capital market in the next few months.

Foreign direct investment which is to garner roughly $2 billion in this fiscal year is unlikely to hit its target because there is a crisis of confidence. Foreign credit agencies still do not view investment in

India favourably. The US-India Business Council report suggests that most foreign companies are waiting for full convertibility of the Indian rupee before they enter or expand their operations in the country. Reason for this is not difficult to fathom. The general economic philosophy of promoting foreign direct investment is based on promoting and facilitating the role of market forces. A common approach in developing countries has been to establish an environment of confidence and stability through the use of macroeconomic fiscal and monetary policy. Moreover, they use microeconomic measures including investment incentives to reinforce the operation of market forces and to foster the changes required by new patterns of demand and supply.

Policy instruments used in developing countries are fiscal incentives like low corporation tax, high depreciation rates and preferential tax system; financial incentives like grants, concessional financing; non-financial measures like provision of infrastructure and business services and incentives at sub-national level like customs free zone. Disincentives on the other hand include local content requirements, export requirements, transfer of technology and so on.

The following table compares these disincentives among competing nations to see its effects on foreign direct investment. Clearly, less disincentives a country has towards foreign direct investment (FDI) more it is able to attract foreign direct investment as a proportion of gross domestic investment (GDI). Furthermore, the current combination of India's high tariffs (by world standard) and two-tiered exchange rate have reduced incentives for foreign direct investment. In particular, the present exchange rate system has affected the bottom line of existing firms which import components and remit profit.

Table 3

Disincentives, including Trade Related Investment Measures in Developing Countries

Country	Sector	Type of Measures				FDI(1990)	
		LC	EX	TT	LE	$mill.	%GDI
India	All	X,X¹	X	X,X*	X	0	0
China	All	X	X		X	3489	2.5
Indonesia	All	X			X,X¹	964	2.5
Pakistan	All	X				249	3.3
Taiwan	All	X					
Sri Lanka	All	X*	X*			31	1.7
Bangladesh	All		X*		X	3	0

LC - Local content, local sourcing, import requirement

EX - Export requirement

TT - Transfer of technology requirement

LE - Local ownership requirement

Measures marked X* denote measures linked to the award of incentives; measures marked X¹ denote measures linked to removal /relaxation of the requirements.

10. Labour

As cited earlier, the labour market reforms are politically most difficult to implement. This is not only the case with India, but with other developing countries as well. The political cost may be excessive to the party in power which legislates outright retrenchment of labour. Hence, an exit policy which was supposed to be introduced by December 1991 in India has not seen the light of the day. At different point of time ministers have made diagrammatically opposite statements in public. However, in the last quarter we have started moving slowly towards a foggy exit policy. Inter Ministerial Working group on industrial restructuring has recommended -- (a) voluntary closure of enterprises, (b) the Board for Industrial And Financial Reconstruction can recommend liquidation, (c) firms to be given more flexibility. A Sub-Committee of the labour ministry has recommended an increase in compensation to workers who are going to be retrenched - from the present 15 days of wages to 45 days of wages for every completed year. It has also been mooted that compensation is to be given in income generating bonds to workers, so that a minimum amount of income per month is available to the workers.

The first indication of labour sector reforms may be inferred from the Cabinet approval to revive National Textile Corporation. This includes much awaited golden handshake scheme for public sector employees. Second, States labour ministers have favoured enactment of a central legislation for organised sector labour. This should pave the way for some legislation to be brought in the winter session of the parliament. The Prime Minister's plea for a three year non-confrontational politics should be seen as preparing ground to bring forth some difficult legislations which are likely to hurt some powerful economic lobbies but these legislations are necessary for the reform programme to succeed. Passage of such legislations may be rough if confrontational stance is taken by the opposition parties.

11. Conclusion

Although there is no change in the content or direction of reform policy introduced by the government last year, the pace of reforms has definitely slowed down in the last quarter as the government bogged down in fire fighting exercise on different political issues. Good monsoons have cleared the clouds of stagflation this year. Given the foreign exchange reserves which would have been spent on buying food *et cetera* can now be utilised in taking bold decisions to improve the competitiveness in goods market. However, overall growth of roughly 3% and average rate of inflation about 10% this year would just allow most of the people to keep their heads just above water. There is still a dark cloud of balance of payment on the horizon. A favourable world trade growth and a competitive exchange rate policy should blow it away.

In medium term, prospects of growth and inflation are favourable if the sectoral adjustment reforms are undertaken at a faster pace. The whole issue of structural and sectoral reforms is not philosophical now but a matter of political will to implement it. The jury is still out but I am optimistic..