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INDIAN ECONOMIC FORECAST: JULY 1994

By

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ABSTRACT

Boom conditions are prevailing in the economy but there is a danger of inflation raising its head again as the foreign exchange reserves go on increasing. The RBI's target of $ 5 billion of foreign capital which it can manage by open market policy will be breached very soon and the bank would be forced to abandon open market operations. With a flow of $ 5 - $10 billion, the RBI would be able to manage with some major changes in the monetary policy but a flow greater than $ 10 billion would force the government to go for full convertibility in March 1995. The government should take a bold step and reduce interest rates by another 2 to 3 percentage points. This would boost domestic investment, draw in imports and prick the ballooning foreign exchange reserves. It would also loosen the pressure on money supply and government deficit.

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1. Introduction

Boom conditions are prevailing in the economy but there is a danger of inflation raising its head again as the foreign exchange reserves go on increasing. Government has taken recourse to liberalise imports of some white goods and intermediate goods. In this paper we would argue that it would not ease supply constraints in the economy.

With a turn-around in political future of the ruling party, it seems that the unfinished agenda of economic reforms would be vigourously followed. The markets can remain calm on the political score after all.

2. Money & Foreign Exchange Reserves

High foreign exchange reserves have become an embarrassment to the government. The development economics literature suggests that countries, which take sustained stabilization and restructure programme, attract net inflow of capital. Such a situation occurred in Ghana and a fall-out of this was an appreciation of their currency *cedis*. There government followed a tight monetary policy with a loose fiscal policy. The policy mainly affected private investment rather than consumption.

Foreign capital - no matter what its source is - would be spent either on imports or domestic goods and services. Money supply would not get directly affected if imports are allowed and if surplus on capital account has an off-setting current account deficit. But, if foreign capital is used to buy domestic goods and services, it creates problem for macroeconomic management. First, domestic prices start going up and inflation persists; second, money base increases as foreign exchange is converted into domestic currency. Therefore, so as not to have the same fate as Ghana, government should follow a tight fiscal policy with loose monetary policy rather than other way round as is being followed at present.

According to the latest estimates, foreign exchange reserves are touching US $ 17 billion in spite of a 13 per cent rise in imports and prepayment of US $ 1.1 billion of the stand by loan to the International Monetary Fund. Foreign funds are mainly flowing from NRI deposits, global depository receipts, investment in the capital market by foreign institutional investors and export proceeds.

As international confidence is growing in Indian economy, the capital inflows are unlikely to decelerate in the next few years. Opportunity exists for the government to make full use of this easy liquidity and create world-size competitive industrial sector rather than put up hurdles in the inflows of foreign exchange because the RBI cannot manage foreign exchange inflows by following an ultra-conservative monetary policy.

The Country Economic Memorandum (CEM) prepared by the World Bank points out that international experience suggests that economies with full capacity utilisation and rapidly growing investment have been able to translate capital inflows into higher investment and higher growth and without appreciation of the real exchange rate. For example, Thailand, Malaysia and Chile received the big inflow of capital as a percentage of GDP when they introduced structural changes. In these countries investment and export growth rose dramatically without much of real exchange rate appreciation.

As foreign exchange assets have been a major component of money expansion, this is a sure sign of increase in liquidity in the banking system. This excess liquidity is with foreign exchange earners and not with people in general, which would be the case if the increase in money supply is the result of the monetisation of fiscal deficit. Hence, before jumping to the conclusion that it is adding to inflationary pressure one must analyse the nature of the inflows and what should be the remedial measure.

One may ask why other countries are interested in investing in a slow growing economy like India. Answer to this question is: these tiger economies are small economies and only a certain amount can be invested within the economies like Singapore, Malaysia and Hong

Kong etc. In India, investment potential in infrastructure sector or other manufacturing sector is quite big. Hence, they are looking for new investment opportunities in India. Some of the South East Asian economies are experiencing shortage of labour, and they are shifting their labour intensive industries to labour surplus countries like India, China and Indonesia.

Although mobilisation of resources by issuing equity in the foreign market is an attractive investment as its servicing is not fixed and the holders share the risks associated with the fluctuations in domestic income and exchange rate changes, these do create long-term claims on the country's foreign exchange reserves. Hence, to absorb the foreign exchange reserves. The widening of current account is of utmost important. The choice is between reduction in domestic savings or increase in domestic investment which can boost long-term growth of the economy and its future capacity to service the inflows. But let us consider the usage of these funds being made in India.

For A rated companies bank financing is available at 15 per cent, commercial paper at 9 per cent and export packing credit in dollars at 5 per cent. But banks are still suffering from an excess of liquidity as banks can earn 10 per cent to 11 per cent on government securities. Therefore banks have not reduced interest rates for medium and small borrowers and still charge them between 18 and 20 per cent and in some cases as much as 22-23 per cent to ascertain that risk adjusted returns are higher than the returns on zero risk rated treasury bills.

Over the past few months, most of the companies which have raised money overseas have deployed large sums in treasury operation. The higher interest rates in the domestic markets provide substantial arbitrage opportunities for companies flush with cheap foreign funds. According to money market estimates, about 80 per cent of the money raised is being used for purposes other than that stated by company managements.

To maintain nominal rupee-dollar rate the RBI is sterilising the inflow of foreign exchange. But sterilisation through intervention is costly. Investment of the surplus forex reserves abroad earns the government around 4 per cent in the US government securities, while the borrowed rupees with which it finances the purchase of foreign exchange costs the government 12-13 per cent. The loss is adding to the centre's fiscal deficit.

The RBI's target of $ 5 billion of foreign capital which it can manage by open market policy will be breached very soon and the bank would be forced to abandon open market operations and make a drastic change in its strategy.

We would argue that this is a direct result of ultra-conservative policy followed by the RBI. To soak up the excess liquidity in the banking sector, the RBI has increased the Cash Reserve Ratio (CRR) by one percentage point to mop up Rs.3,700 crore from the banking sector.

To be fair to the government, it has been reported that the Union Finance Ministry has short-listed three steps to be taken to absorb the foreign exchange flows in the economy. These steps are, further opening up of imports, appreciating the value of the rupee against the dollar and cutting interest rates on bank loans. These steps are being examined at the highest level in the Ministry.

The present world financial markets suggest that there would be some respite from inflow of greenbacks through portfolio investment as prospects of European and Japanese growth rate brighten and big global investors are attracted by relatively cheaper and better performing Japanese, German, Swedish and Danish stocks.

There is no shortage of global liquidity yet, but it has passed its peak and financial markets are signalling this through the sudden divergence between bond and commodity prices.

The government is soon going to relax transactions on capital outflows. If the Reserve Bank of India does that, it would reflect the self confidence that monetary authorities have in monitoring end-use of foreign exchange. This would send a welcome signal in the money market that authorities are convinced of continuous foreign exchange inflow in the country. Allowing domestic investors to invest freely in the developing markets would provide impetus to Indian large companies to become multinational companies. The credit policy announced in mid-May was essentially a conservative and unimaginative policy to mop up liquidity in the economy. Korea, Malaysia and Indonesia, all have exploited foreign exchange reserves for investment and boosting growth. Keeping foreign exchange reserves in low yielding US government bonds is too conservative a practice which we can do without.

With a flow of $ 5 - $10 billion, the RBI would be able to manage with some major changes in the monetary policy but a flow greater than $ 10 billion would force the government to go for full convertibility in March 1995. This would be good news for emerging multinational companies of Indian origin as given the reservoir of talented employees, these companies, both in manufacturing and service sector, can forge ahead with trading cum manufacturing alliances which would allow them to skirt around tariff wall in many of the trading blocks which exist around us in the present day world.

3. Unfinished Agenda

In the All India Congress Committee (I) meeting in Delhi, the ruling party adopted the economic resolution which suggests that they have overcome the modesty over the liberalisation process. Now, the liberalisation process has become the ruling party's economic agenda. Interestingly, the resolution says that 'the public sector must become profitable', and 'social obligations are best met when public enterprises make profits, not losses'. The Rangarajan Committee Report on disinvestment of public sector undertakings may get implemented by default but the Goswami Committee Report is unlikely to be implemented. However, the implementation of labour laws in states and changes in Urban Land (Ceiling and Regulation) Act may be brought about by states themselves as they face competition to attract investment in their states. In fact, in Maharashtra and Gujarat already some progress has been made.

The resolution has also taken a forthright stance in favour of the GATT accord. Opposition who threw bricks rather than bouquets on the GATT treaty have been told off not only by domestic industrialists but also by voters. Opposition leaders seem to be out of line with economic liberalisation.

In its 1994 Annual Report, the IMF has warned India that it must reduce fiscal deficit to remain on a dynamic growth path and the recent increase in inflation and strong international capital flows suggest that things are not as bright as they may appear. India should not be smug about its balance of payment situation and must speed up structural reforms i.e. go ahead with privatisation programme and reforms in the labour sector.

India has been awarded US $ 3 billion concessional loan by the World Bank for keeping the economic reforms going and reducing trade barriers, tariffs etc. But there is a warning too, that there are still large number of people living under abject poverty and there are bottlenecks in the infrastructure facilities. India has to keep not only the reform programme going but also spend money on rural health, education and infrastructure. Investors are putting money in India in the hope that their money is returned with interest as Indian economy expands. Therefore, aid has not become redundant or need for aid has not diminished. India needs aid for social infrastructure which is beyond financial market.

As social and economic infrastructure is handled by states, the agenda of economic reforms has moved to state level and states are vying for more-and-more investment in their states. Even a socialist Chief Minister of UP, Mulayam Singh Yadav is booing industrialists to invest in UP. He talked to the Confederation of Industrial industries to attract investment in his state. He is likely to visit the US and Singapore to chase more green backs.

The Trade and Industry associations are gunning for more concessions as they recognise that the new economic policies have made the state governments, irrespective of their political beliefs, realise that they would have to deregulate and provide incentives to investors otherwise there may be a migration of industries and skilled personnel from their state to other more developed states.

Deregulation of procedures is important in an over-regulated command economy. Infrastructure is equally important in attracting foreign direct investment especially. Foreign investors, for obvious reasons, like to set up their plants and offices in a state which has a modicum of infrastructure in the form of good roads, power supply and communication network. Failure in any one of these facilities may upset the investors. For example, a study done by the Indian Institute of Foreign Trade suggests that foreign companies are getting disillusioned with Bangalore because of frequent power failure and transport problems.

The Confederation of Indian Industries (CII) has demanded that sugar, drugs and electronics industries should be totally delicensed and deregulated. Their demands are unlikely to be met in toto. However, significant changes in the regulation of sugar and drugs industry are on anvil. Price control on drugs would continue for the time being although there would be some relaxation in prevailing norms.

The Union Finance Ministry has decided that it will now allow public sector units (PSUs) in the state sector to directly negotiate external loan with donor countries as well as multilateral agencies like the World Bank. The disintermediation worked well with the central PSUs and hence, it has been decided to extend the principle to state PSUs. But, the government hardly has any choice in this matter.

However, the question of raising resources at state level has not been adequately addressed. The National Institute of Public Finance and Policy, which was commissioned to give a report on central-state revenue sharing, has recommended a dual system of value-added tax. Under this the VAT is levied separately by both the centre and the states. It is hoped that under this arrangement states need not fear loss of revenue when the VAT is introduced. The RBI also wants that state governments should enhance their non-tax revenues and power tariffs and water charges must be raised.

As Enron is demanding that the dispute over counter-guarantees be heard in a foreign country and not in an Indian court, it is making up the Finance Ministry sit up and realise that apart from having an independent judicial infrastructure, India needs to review economic laws which would streamline economic laws and, at the same time, cut down on the cost of litigation and time taken in clearing cases. The demand by a foreign company is a slap on the face of Indian judiciary.

International business community accepts India's commitment to reform, albeit on a gradualist track. But this also means that the drip of reforms must be visible all the time being injected into the Indian economy.

In short, with a turn-around in the political future of the ruling party, it seems that unfinished agenda of economic reforms would be vigourously followed. The recent mid-term election victories have shown that silent majority of people who have not gained much from the on-going reforms are hopeful to be benefited in future. Therefore, they have chosen to elect the ruling party candidates in by-elections. But, nobody should expect reform process to be without some bumps or absolutely trouble free.

4. Privatising Country Risk

In the unipolar world, capital is moving more freely world-wide. The process has been encouraged by the broad liberalisation of financial markets in the developed countries as well as developing countries. The national boundaries have become pervious to financial flows and present a direct challenge to the financial power of governments and 'Keynesian' economics for which national boundaries are necessary. As exchange controls are lifted, fiscal policies of governments come under sharp focus of financial markets and result in the pressure on the currency.

World-wide, as a result of privatisation and tight fiscal stance in the last decade, international banks' exposure to public sector has reduced and they are more exposed to banking sector and private sector (Figure 1). However, in India, exposure to public sector pre-dominates banking and private sector (Figure 2). But, this is sure to change in the later half of nineties.

Governments, all over the world, are increasingly dependent at the mercy of financial markets and only consistent economic policy can keep markets quiet. Inconsistent policies may see volatility increasing or even where actions are not taken at appropriate time markets may turn volatile as we have seen rapid depreciation of dollar world-wide and the case of sugar in India recently.

Fig. 1: International Bank Exposure by Borrowing Sector

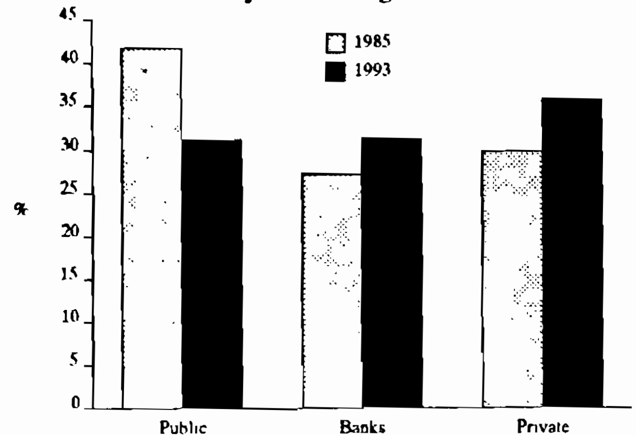
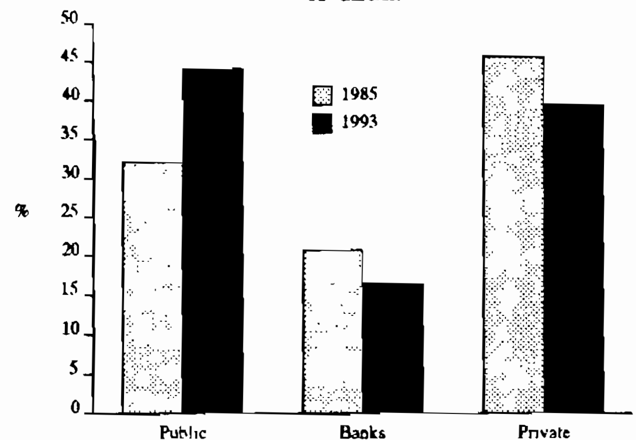


Fig. 2: International Bank Exposure to India



With capital mobility government's ability has been curtailed to finance its fiscal deficit either by printing money or borrowing excessively as market calls into question the value of the currency and have the option of not buying the debt. These financing pressures and need of emerging economies to finance their social and economic structure have become important international economic issues. The global prosperity, to ensure growth in developed nations, depends on successful integration of emerging economies in the world economies. Hence, infrastructure development and its funding has become the main issues of international economy today.

Realisation of this can be gauged from Mitterrand's speech at Naples Eastern University just before the G-7 meeting where he accused the affluent nations of neglect of the third world and said, 'This G7 in Naples ... is an op-

portunity to underline that the gap between the rich countries and the poor countries is constantly growing, and the group must take bolder measures'.

As noted earlier, the need of aid has not diminished in the developing countries. But, past experience of the World Bank suggests that aid has been misused or returns from that are not enough. Basically, businessmen would argue to give them aid which they can utilise better than the government.

A study funded by the Asian Development Bank on private highways showed returns as high as 35 per cent. The projected returns seem too good to be true and that is borne out by average returns of 16 per cent for a large sample of World Bank projects. What is interesting is that the poor returns are caused by incorrect assessment, inefficient operations and poor cost recovery. Hence, governments all over the world, who are interested in increasing private participation in infrastructure projects in their countries must address some of these causes.

The annual meeting of the IMF and the World Bank will be held in Madrid from October 4-6 at the Campo de les Nociones. This year's meeting, on the occasion of the 50th anniversary of these two organisations, would take stock of their accomplishments and failures and set the course for the future.

The World Bank has already set up new guide-lines. At the centre of it is greater partnership with private sector. Five key areas would dominate its future agenda and its relationship with member-countries.

- Pursuing economic reforms to have broad based growth to reduce poverty.
- Investing in people by expanding investments in health and education sector.
- Protecting the environment.
- Simulating the private sector to become more productive.
- Reorientation of public sector such that it encourages efficient public sector, which would complement the public sector.

Much of the work done so far by the Bank would be done by private sector and the Bank would concentrate on poor states. Guiding principles for the World Bank now are to be client oriented in response to client needs, result oriented, cost conscious and have financial integrity.

The Asian Development Bank (ADB) has not formally announced its future agenda but it is implementing more or less the same agenda as that of the World Bank. In fact, the ADB has approached the Government of India to lend directly to power saving industries like paper, aluminium, cement etc where returns of 10%-15% are assured and as much as 20 per cent savings are envisaged.

The new philosophy is also reflected in the Country Economic Memorandum which has clearly stated that 'the sector level policy and institutional frameworks are not yet sufficiently supportive of private investment'. The government has invited private sector participation in the infrastructure facilities but the government is still undecided on issues such as returns, pricing, acquiring of land etc.

Keeping up with the philosophy of privatising country risk, the latest World Development report has emphasised infrastructure development in the developing countries but it wants to harness power of the markets to provide better infrastructure facility. According to the report the resources have been squandered by poor maintenance, building infrastructure with incomplete planning, running the services inefficiently and pricing the services below cost. To remedy this, the World Bank wants infrastructure to be run like a business without political interference. It hopes that private sector participation would improve efficiency. Second, increase competition within the services sector and third the consumers should be involved in planning, designing and paying for the projects especially at the local level. As private sector comes to play a bigger role in building and financing infrastructure, the role of the Bank and the government would diminish in the economic life of the country.

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5. Forecast

5.1 Exogenous Variables

5.1.1 World Trade

Growth in the G7 countries is likely to average 2.2 per cent during 1994, twice the rate recorded last year. This upturn is largely due to the robust growth in the US, but recent data has suggested that the economies of Japan and Europe have started to revive.

The strong growth in the US economy in the first half of this year has boosted world trade, although the latest data suggests that the economy has lost a little zip. But, the momentum in economy should allow growth to average nearly 4 per cent during 1994 as a whole.

The desynchronised nature of the present world economic cycle is still very evident. The US is now about three years ahead of Japan and Germany in its cyclical position. Worries about the inflationary pressure in Japan and Germany have given rise to fears of growth being stopped in its track. The upturn in Japan is likely to be affected by the appreciation of the yen. It is estimated that only 6 per cent of businessmen in Japan can make profit if ¥/$ rate is below 100. At present yen is over-valued and the US $ is cheap. In Germany, the question is whether export growth can offset the effects of fiscal tightening on domestic demand.

The run up in both, commodity and oil prices in the last few months reflects the anticipation of higher demand as the world economic outlook brightens. The upward trend has been reinforced by speculative activity.

Growth in 'Tiger' economies would average around 7.5 per cent if world economy grows by 2.2 per cent in 1994. India and China both, are competing for foreign direct investment and would continue to do so in future. But they have agreed to exchange notes on problems being faced by both of them to strengthen their cases in world forums.

5.1.2 World Interest Rates

World interest rate changes will move further in favour of the dollar as US interest rates rise and sluggish German growth forces further rate cuts in the German interest rates and is followed by other EC countries.

World bond markets have had an extremely difficult period in the last quarter. The pressure on the dollar has increased the chances of higher short-term rates in the US. The cumulative falls in bond markets over the first half of the year have unnerved the investors. It was the event in Korea that had defined this growing unease about the leadership of the West or rather the lack of it. It was the past memories of Korean war and what it did to commodity markets, inflation and the world economy which had upset the investors. As the threat of another Korean war is out of the way, markets are expected to calm down. Some of it can be seen in dollar rising again and reaching 100 ¥/$ level.

Table 1 - Exogenous Variables

	1993	1994	1995	1996	1997
World					
Trade growth (%)	1.5	3.2	3.5	4.4	4.5
Real Short-term Interest Rate	1.6	1.8	2.5	3.2	3.2
Real Long-term Interest Rate	2.9	3.5	3.5	3.5	3.5
O.E.C.D. Inflation	2.7	2.1	2.4	2.7	2.7
Crude Oil($/barrel)	15.5	15.0	15.0	16.0	16.0
Domestic					
	93-94	94-95	95-96	96-97	97-98
Rainfall (% of normal rainfall)	101.0	101.0	92.0	92.0	92.0

What has happened in the first few months of this year is that a huge amount of money has outflown from bonds and equity market. The players who moved their money were highly leveraged players. Game of survival has been played i.e. basically trying to preserve money, unlike the older game where capital moved from one market to another depending on yield or other normal concepts with which economist are used to working.

The helplessness of industrialised countries to move the financial market is illustrated by the G7 meeting in Naples. They know that the combination of floating exchange rates; free, competitive and integrated capital markets subject to financial flows of impressive volume and speed; and the reluctance - or inability - of industrial countries to formulate coordinated policies, have made financial markets all but impervious to institutional exhortion, much less disciplined.

Derivatives have emerged as the latest pathogen for financial analyst. It was thought that derivatives market which has grown from nominal to $ 15 trillion against the US GDP of only $ 6 trillion, needs some control and only a coordinated G7 nations can provide such a leadership as they provided against $ in the mid-80s. The G7 countries do not think that they can control this market as Germany made it abundantly clear when the US $ came under fire that it was US problem. Whatever the Finance Ministers of G7 countries think, the need to control this monster is there.

5.1.3 Oil Prices

The oil price has rebounded from its five-year low of around $ 13 a barrel in February. The price has now risen to around $ 17 a barrel and brings the price back to around its year earlier level. The increase was the result of cold weather in the US in early 1994 cutting into inventories and the expectation of higher demand during the rest of 1994 as the world economic upturn gathers place.

Further, firming up of crude oil prices are due to the fact that the International Energy Agency expects world oil demand in the fourth quarter to be higher than it had previously forecast. They reckon that demand for oil will total 69.6 million barrels a day in the fourth quarter - roughly 300,000 barrels a day more than it had forecast last month. They expect that demand of oil in Asia is greater than the earlier forecast.

OPEC's next ministerial conference is planned for November 16 in Vienna and in their March meeting they had agreed to keep output running at 24.52 million barrels per day until the end of the year.

The flow of Iraqi oil is beginning to fade as a threat to petroleum prices although it may flow into oil markets sooner than some expect. The UN Security Council again rejected Iraq's plea to ease the economic sanctions against Iraq. Still, Iraq is winning support from important UN members - including Russia, France and China. The lifting on ban is possible next year as the US stance would mellow down and if spot oil prices cross US $ 20 mark. The US would agree to economic sanctions as higher oil prices would affect the sustained US economic recovery. Most of the analysts agree that the lift of UN sanctions would see an immediate price drop of $1 - $2. Iraq's production capacity at present would add roughly 1.5 million barrels a day to world oil markets.

Nigeria is the tenth largest producer of crude oil which produces 1.6 million barrels per day and most of it is exported to Europe. Due to strike by oil workers in support of freeing detained leader Abiola, there is a fear of shortage of oil in Europe and hence, there is a spurt in oil prices temporarily.

The firming up of international oil prices has hastened the Indian government to offer deep water blocks in India's exclusive economic zone to foreign companies for exploration. The supply of petroleum and petroleum products by 1997-98 is expected to be smooth but India is expected to remain dependent on the import of oil in the long-term. Indigenous crude oil production is likely to increase from 27 million metric tonnes in 1993-94 to 44.5 million metric tonnes in 1997-98, which is a compounded growth rate of roughly 13 per cent.

5.1.4 Domestic Rainfall

The country has received excellent rainfall so far in all the meteorological sections of the country with good spatial and temporal distribution. According to meteorological estimates the country would receive as much as 101 per cent of long-term rainfall. As many as 80 per cent of the meteorological districts have received normal or excess rainfall so far. In our last forecast we had assumed a normal rainfall i.e. 100 per cent of long-term average.

If the crucial *hathia* rains materialise in late September and the beginning of October, it would ensure not only a bumper *kharif* crop but also a promising start to the *rabi* operations.

5.2 Endogenous Variables

5.2.1 Output

At the very least, the behaviour of the monsoon so far has dispelled fears of any setback during the current agricultural year. The growth prospects are further corroborated by the business outlook survey of the Confederation of Indian Industry and the latest business expectations survey by the National Council for Applied Economic Research.

5.2.2 Agricultural Output

Prospects of a bumper *kharif* crop harvest are bright as rain god has been extra bountiful to the country. So far the country has received excellent rainfall. Its spread has been much better than what it was last year. We forecast a 3.4 per cent growth rate in total agricultural production and a 3 per cent growth in foodgrains production this year. Hence, total foodgrains production is expected to be roughly 185 million tonnes in 1994-95. It is 4 million tonnes short of official target which is difficult to achieve.

The government announcement about enhanced prices of *kharif* crops gave a fillip to sowing. The prospects for cash crops are excellent; in particular, welcome rains in Gujarat have boosted the chances of a bumper oilseeds harvest this season.

Production levels of some foodgrains have overtaken market demand. The substitution of vegetables, fruits and

milk products in the consumption basket of people is reducing the demand of cereals and India is almost reaching the stage of surplus foodgrains producers, thanks to sustained increased in procurement prices and reduction in subsidies to the consumers. Again, open market prices of foodgrains are unlikely to be much different from minimum support prices. If government does not export foodgrains to deficit countries or offload it in international market, it will have large number of angry farmers in many states where FCI officials use indirect means to deter the farmers to sell all their surplus to FCI. This forces farmers to be little more innovative and work as producer-trader and sell their produce directly to consumers at a marginally lower than the minimum support price.

At present granaries are overflowing with 26 million tonnes of stocks as against 20 million tonnes last year and the norm of 14.5 million tonnes stock. Therefore, it would be prudent to follow an open market policy where government buys in good years and offloads stocks in years of shortage. This should be accompanied with an open trade policy for agriculture to allow farmers to reap the gains of competitiveness which India has in a number of crops.

The decision to hike urea prices by 20 per cent while retaining the Rs.1,000 per tonne subsidy on phosphatic and potassic fertiliser could help in proper utilisation of nitrogenous fertilisers.

5.2.3 Non-Agricultural Output

The Industrial sector growth prospects are corroborated by a business expectation survey of CII, where respondents felt that industrial output would rise substantially in 1994-95. The survey has indicated that the industry is more optimistic this year than it was last year. The general expectations of large companies is that there will be stepped up expenditure on plant and machinery during the current year.

A spurt in imports in the first two months of 1994-95 should also be taken as positive proof of industrial recovery on the way. Booming automobile sector and sustained growth in power generation and saleable steel are a further indication of industrial growth.

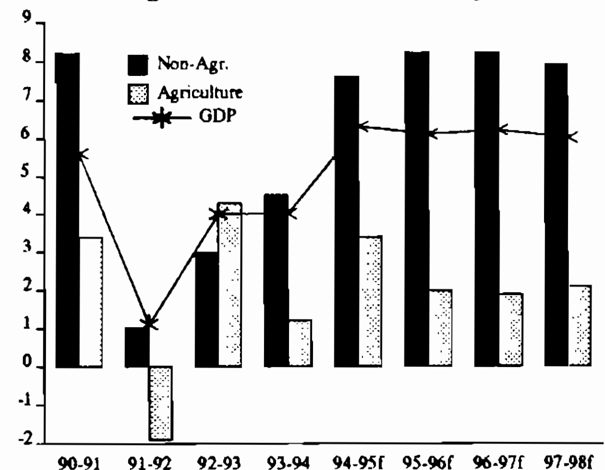
One of the good signs of non-agricultural output has been in the power sector. Electricity generation in the country rose by 7.34 per cent during 1993-94. A month by month analysis shows a sustained growth rate in power generation during 1993-94. In March, electricity generation recorded a 10.73 per cent growth. This is on top of 5 per cent growth in 1992-93. The reason to be cheerful about a good growth in electricity generation is that to utilise the existing capacity one of the essential inputs is non-interrupted electricity supply and even if some of it is going in domestic consumption, that raises domestic demand for durable goods etc. The industry has to bear heavy burden if it has to put up captive plants for that.

Table 2 - Forecast

	93-94f	94-95f	95-96f	96-97f	97-98f
GDP growth (%)	4.0	6.3	6.1	6.2	6.0
WPI (%)	8.3	8.6	7.9	7.6	7.7
CPI (%)	7.3	7.5	8.1	7.8	7.6
Exports (%GDP)	9.3	10.1	10.4	10.7	11.0
Imports (%GDP)	9.7	10.2	10.7	10.9	11.1
Current a/c (%GDP)	-0.1	0.5	0.2	0.1	0.1
Current a/c ($ bill)	-0.2	1.3	0.7	0.4	0.5
Exchange Rate (Rs/$)	31.4	31.2	32.6	33.4	34.0
Production (growth p.a.):					
Agriculture	1.2	3.4	2.0	1.9	2.1
Non-agriculture	4.5	7.6	8.2	8.2	7.9
Investment (% gdp):					
Private Sector	15.5	16.6	16.0	16.0	16.2
Public Sector	8.7	8.2	8.1	8.0	7.9
Govt. expdt. (%gdp) (Central + State + UTs)	31.2	31.0	30.8	30.7	30.5
Fiscal deficit (%gdp)	7.6	6.0	6.0	6.0	5.8

e - estimated figure f - forecast figure

Fig. 3: Economic Growth (% p.a.)



Several sectors like steel, automobiles, aluminium, textiles and cement are poised for a sizeable growth. Demand of these products in the wake of expectations of bumper *kharif* crop would be buoyant and higher price realisation is also possible.

Public sectors are also coming out of their closets. As they have to look for funds in open market they are

forced to look for new avenues to enhance their revenue. Hindustan Shipyard Ltd (HSL) - a public sector company which was in red for many years - has gone in black. It has smelt new opportunities in ship building industry as ship building is moving out from Korea and Japan to India and China; HSL hopes to capitalise on opportunities.

The industrial production during the month of February 1994 registered a growth of 6.6 per cent as against -4.7 per cent in February 1993, with the manufacturing sector recording a growth of 7.4 per cent as compared to -6.7 per cent in February 1993. We expect non-agricultural sector which includes service sector as well to grow by 7.6% in 1994-95 and above 8% in the second half of nineties.

5.2.4 Inflation and Interest Rates

The retail prices in the last two months were hovering at less than 10 per cent but it has accelerated to 10.6 per cent in May 1994. This is the first time since September 1992 that consumer price index has crossed the double digit mark for industrial workers.

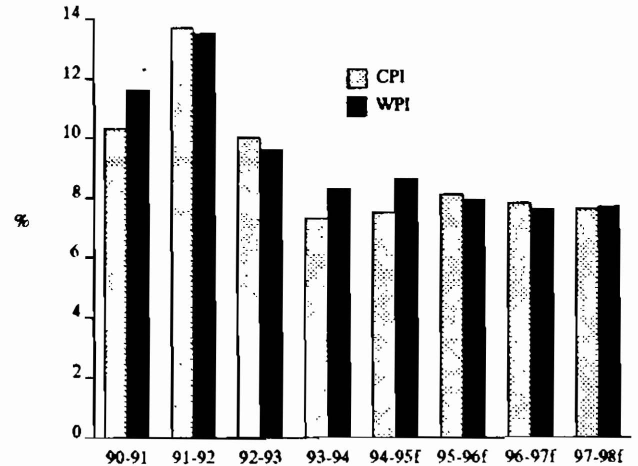
One of the leading indicators of inflation is growth in money supply. In India, mostly growth in M3 is reported. M3 includes narrow money, M1 and bank deposits. M3 grew by 17.8 per cent in 1993-94 and is expected to grow by 20 per cent in 1994-95 as increase in foreign exchange reserves puts pressure on the growth of reserve money. However, studies have shown that it is M1, narrow money growth which purports to transaction demand in the economy, rather than M3, the broad money measure, which is a leading indicator of inflation. But, M1, itself is growing in the 19%-20% range hence, it seems unlikely that inflation (WPI) will be below 8.5 per cent for 1994-95 and CPI which tracks WPI will be around 7.5 per cent.

The minimum support prices of coarse grain which were increased by Rs.20, and a nine per cent hike for rice in June in the wake of 20 per cent increase in urea prices would unravel into higher consumer prices in early January when prices of these are raised to keep a check on food subsidy.

In the Indian Development Forum the additional secretary for economic affairs has indicated that increase in power tariff and coal prices are under consideration. This is further emphasised by the Power Minister Mr. NKP Salve who announced last month that power tariffs would go up shortly as it was not possible any more for the government to give subsidies to the energy sector.

The Finance Minister's hope of reduction in consumer prices is based on the premises that new crops would hit the market in September and hence the consumer price index would become steady may not come true due to increase in prices of sugar, oil and cotton.

Fig. 4: Inflation (% p.a.)



It is true that inflation is a monetary phenomenon i.e. inflation will be there where there is a rise in money supply, no matter what the source of money is. But, in India, increase in money supply in the past was caused by government trying to take bigger share of the economy and pay for it by printing money. This was euphemistically called 'Net RBI credit to the Central Government'. But, this factor has not been responsible for rise in money supply in the recent past and hence the increase in money supply is not a root cause of present inflation. The second factor which until 1991 did not play a major role is increase in administered prices. In fact, the administered prices are raised to contain fiscal deficit but they also provide a floor below which prices would not fall in open market, especially for wage goods like sugar, rice and other cereals. The third factor which causes inflation is fiscal deficit. No doubt fiscal deficit is large but if one looks at the sums it is interest paid on domestic debt which is ballooning and causing fiscal deficit to rise. This is a direct implication of sterilisation of foreign exchange inflows.

Hence, the main culprit for ballooning fiscal deficit, increase in money supply and foreign exchange reserves is high interest rate, which is being further sustained by RBI's open market operations. The RBI must cut minimum lending rates by 2 to 3 percentage points even if it means reducing deposit rates. This would reduce the arbitrage opportunity which exists at present for large companies to bring in money by issuing GDRs and employ it in money market. It is good to have profitable private sector but that profitability should come from their trading and manufacturing activity rather than transforming themselves into a quasi-financial company. We must take a

leaf from the experience of Japanese Kashima oil, the German metal co. Metallgesellschaft, Procter & Gamble Inc. and even the Malaysian Central Bank, Bank Negara, who have burnt their fingers in forex market and financial derivatives recently.

By reducing interest rate, RBI would be able to utilize some of it low yielding securities for open market operations which it is not able to use as it would involve a heavy loss to the central bank.

5.2.5 Trade Balance, Imports and Exports

The expected growth of 15 per cent in exports would be on top of the 20.4 per cent growth rate achieved in 1993-94. The 1993-94 export growth was over a low base of 1992-93. The growth in imports during the current year is expected to be around 13 per cent in 1993-94, as a result of the expected pick up in the industrial activity. Thus, 1993-94 is expected to end with a balanced trade and a clear surplus on the current account.

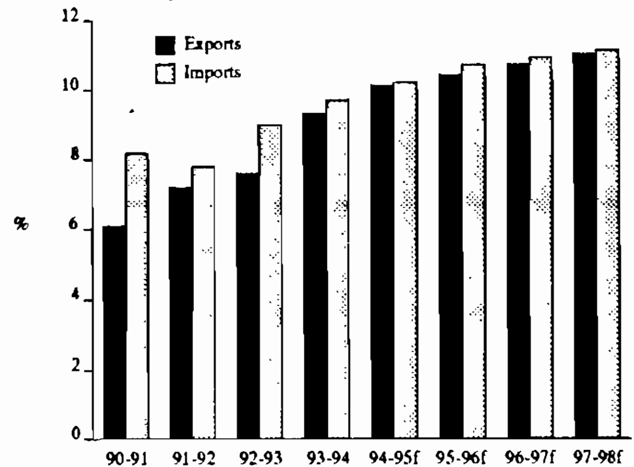
The World Bank has warned the government against providing guarantee to foreign investors in the power sector as fiscal consequences of providing guarantee are unpredictable and have potentially large destabilising effects. In a bid to woo foreign direct investment the government is unlikely to heed this warning.

The Exim policy of the government was relaxed in late May and again in late July. The unprecedented flow of foreign exchange mainly through GDRs and portfolio investment has forced government to change foreign exchange restrictions on current account. Government has liberalised imports of several consumer durable goods, petroleum products and electronic equipments. These items are allowed to be imported under freely transferable special import licenses, granted to export houses, trading houses, star trading houses and super star trading houses.

For a growing economy with high growth rate, we expect trade balance to be negative. In simple words, it means that economy is building up productive capacity to service the growing domestic and international demand. As long as the current account deficit has offsetting surpluses on capital account, free trade in goods and services is going to be beneficial to the economy.

During 1993-94 imports grew by 6.9 per cent giving rise to trade deficit of $ 1.04 billion which is far less than the deficit of $ 3.4 billion recorded for 1992-93. Invisible sector posted surplus in 1993-94, thanks to increase in tourist traffic. The current account deficit in 1993-94 was only $230 million or 0.1% of GDP.

Fig. 5: Exports & Imports (% GDP)



Thanks to the steady fall in crude oil prices in 1993-94, the oil import bill dropped by US $ 500 million compared to 1992-93. The firming up of oil prices would have affected trade balance in 1994-95, but as ONGC is increasing its output the changes in spot oil prices would not affect trade deficit substantially.

Our forecast for export growth rates in dollar terms remains at 15 per cent for 1994-95 as it was in our April forecast; even though emerging scenario of world growth is better than our April forecast and domestic GDP is marginally higher. All extra domestic growth is going to come from agricultural sector and improvement in world trade growth is going to be marginal in 1994 but in 1995 it is expected to be better. Accordingly, we forecast that in the second half of nineties exports would grow by 10 per cent in dollar terms. Commerce Ministry's target of 25 per cent growth rate in exports on average until 1996-97 is bit optimistic and even well above the Ministry of Finance's expectations of 15 per cent growth in exports for the current year.

To promote exports the Finance Ministry has decided to provide a Rs. 225 crore grant for setting up one export promotion industrial park in each of the 25 states. The Central Government is going to provide upto Rs.10 crore to set up infrastructure facility in each of the states in the park but allocation of funds for this would be routed through normal annual plans.

Indian PM's main aim to visit Moscow was to boost bilateral trade and improve relations. Given the stock of Russian armaments with India, India has to keep on buying from Russia, but defence imports cannot be paid for in hard currency which our exports get from other countries. Russians, who used to buy consumables from India earlier, have started buying these items from other countries. Hence, the PM's top priority was to make Rus-

sians buy Indian goods again and if the PM has to haggle over the price of a cup of tea, so be it - that is what trade diplomacy requires.

Prime Minister Rao's visit to the US in terms of building up trade relations and attracting foreign direct investment has not materialised into large investments yet but it has created a lot more interest of corporate America in Indian economy. The way American politics and investment work, it is necessary to have a group of companies who would take up cudgels with the administration on behalf of India and that is possible only when they have business interest in India. To that extent Prime Minister's visit has been successful and Indo-US trade relation would further get cemented when the US Trade Secretary Ron Brown visits India in November.

The central purpose of Mr Rao's US visit was to underline the fact that the countries now share a common economic outlook and to show-case India's economic reforms and accelerate the fast growing ties between the two countries.

The Sino-Indian trade protocol signed last month is going to be mutually beneficial. At present roughly $ 700 million worth of trade takes place through a third country, mainly Hong Kong. But, direct shipping links do not exist between China and India. Otherwise, this trade can take place directly. However, the protocol signed underline the importance of bilateral trade.

India and China's bilateral trade has a potential of $ 25 billion according to a report prepared by Centre for Global Trade Development, a US based research and information group. Although the report is very optimistic about the growth rate of China and India in 1994, its diagnostic is correct that bilateral trade between these two countries would create huge and unprecedented opportunities. The report suggests that Indian exports would touch US$ 90 billion by the year 2000 on the basis that industrial sector growth would average 15 per cent. This is an optimism of a dreamland and cannot be achieved.

Economic ties between South Africa and India would get enhanced when the Commerce Minister visits South Africa in the last week of August and both countries grant each other most favoured nation status. Trade with South Africa would enlarge through direct links between the two countries.

The potential of south-south trade has been recognised by the government belatedly. To boost imports from Bangladesh, Sri Lanka and Korea, the customs duties have been reduced by 10 to 20 percentage points. South Korea is likely to make most of the duty concessions.

5.2.6 Exchange Rate

The policy of rupee pegged to the US $ is not helping exporters or the economy. Hence, the RBI is toying with the idea of prescribing an adjustable price band of 3 to 4 per cent i.e. rupee may be allowed to fluctuate between 31.50/$ to 33.50/$. What it means is that the day-to-day intervention by the RBI in the forex market would not be necessary. By allowing rupee to fluctuate within a band would permit it to find its own level and the management of forex reserves would not pose problems.

Though capital inflows have placed the nominal exchange rate under pressure to appreciate, it is unlikely that government would allow the competitiveness of the exchange rate to be eroded as India is developing its export base and gaining a foothold in world markets. The maintenance of a stable and competitive real exchange rate remains one of the main objectives of government economic policy.

5.2.7 Private Sector Consumption

The buoyancy in rural income as a result of bumper crop would fuel the overall demand. Passenger vehicle sale has increased by 20 per cent in the first quarter of 1994-95 and there is a waiting list of six months for some models. The spurt in demand is due to the release of pent-up demand of last two years, easy availability of funds and a drop in interest rates on car finance.

Consumer demand is expected to grow on sustained basis as India is poised for over six per cent annual growth in its GDP in the next five years. Other than China, India has the largest market of over 200 million strong middle class.

5.2.8 Private Sector Investment

The donors in Indian Aid Consortium meeting have told India that it should continue to liberalise its investment policies. The World Bank is especially concerned about the power sector, where private investment is deterred by inadequate prices. And agricultural policies, with numerous state interventions in domestic agricultural markets, are hindering private corporate investment.

The focus at the meeting was on attracting private investment. For the first time the delegation included Indian industry and banking representatives. After meeting the government representatives, the delegation met

western bankers and senior officials of emerging markets funds and multinational corporations.

According to the business outlook survey of the Confederation of Indian Industries (CII), the industry expects increased investment on plant and machinery between April-September this year and prospects for future investments are good.

Reforms in import tariff structure implies that industry must invest to become competitive and growth oriented, then only industry can achieve a growth rate of 10 per cent in the later half of the nineties. Interestingly enough 80 per cent of FDI approvals have been in priority industries. So far, fuel and refineries have attracted 17 per cent, power sector 16.5 per cent, food processing 9.7 per cent, metallurgical industries 9.5 per cent and electrical equipment and electronics 7.9 per cent. The breakup of log-jam in the telecommunication business should see improvement in overall productivity of the economy.

The central government has reluctantly approved in principle sovereign guarantees for seven projects in power sector. What it means is that if a state government defaults in paying for power from private foreign generating companies, the central government will pay. The Power Ministry has argued with the Finance Ministry if such guarantee is not given no PDI would be forthcoming in the power sector.

The sovereign guarantee to make initial headway in the power sector and other sectors is understandable but keeping it as a standard practice for foreign or domestic participation in infrastructure project would be harmful to the economy as prices calculated on cost plus method would lead to capital intensive investment in the economy.

Indonesia has already changed its law on foreign direct investment to make it more attractive for foreign investors to invest in their country. India, if it wants to attract FDI cannot but give similar type of incentives to foreign investors. According to FICCI, the policy makers are considering major changes which would form the next phase of reforms. It is likely to include National Investment Law which would include existing policy and practices relating to dividend repatriation, disinvestment, employment of foreign national and bilateral investment treating. There is a possibility that the list of industries eligible for automatic approval for foreign equity from 51 per cent to 75 per cent will be enlarged.

5.2.9 Government Expenditure & Investment

There are good chances that fiscal deficit would remain within 6 per cent limit. First the current year has been started with a clean slate because expenditure from 1993-94 has not been passed to 1994-95,. Second, this year the Central Government has displayed its determination to impose fiscal discipline on the states even though it has raised the states' limit of the ways and means advances by 50 per cent. Third, the buoyancy in indirect tax collections during the first quarter suggests that the Finance Ministry's policy on switching over to ad valorem rates for excise duty on most items and on reducing import duty on a wide range of items has paid off.

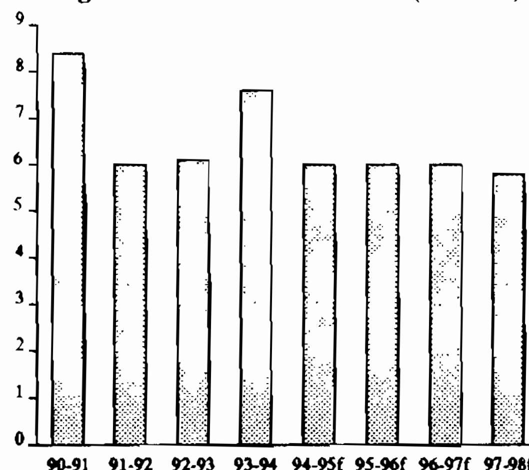
The customs and excise duty collection in April-June 1994 have grown by 12-13 per cent over the previous period. Furthermore, a 12 per cent increase in imports during April-May 1994 has boosted import duties and as import of non-petroleum products has grown on an average of 25 per cent per month since December 1993, the industrial growth rate of 7-8 per cent in 1994-95 is not difficult to achieve. It is reported that the customs revenue increased by 70 per cent at the Kandla Customs House between April-June this year compared to corresponding period last year. However, the revenue growth is short of the 18 per cent revenue growth required to meet government targets.

The plans announced by Surjit Singh, Principal Collector of Customs in Bombay, to speed customs clearance and tax collection would go a long way in improving revenue collection and cutting costs.

But, as government deficits are of unusual nature, in the sense that a large part of fiscal deficit is due to debt interest payment, it would be prudent to plug deficit by disinvesting in PSUs and if possible reduce the stock of domestic debt so that more money is available to spend on social infrastructure.

Government 365-treasury bills yields are roughly 10 per cent. This will add to debt interest payment and can make budget deficit targets difficult to achieve. Bond

Fig. 6: Central Govt. Deficit (% GDP)



yields should be eased from their present level, otherwise additional debt interest payments would eat into government expenditure next year.

Russian defence production industries are looking for tie up with Indian industries to the order of US $ 300 million. This tie up is for manufacturing parts etc. The companies which are going to benefit from this are Hindustan Aeronautics Ltd and Bharat Electronics Ltd. Not only public sector companies, but private sector companies like L & T are also going to benefit from the Russian deal. This deal is going to have long-term benefits because Russians want to have a foothold in the world armament trade. According to defence analysts, in the past, on the strength of arms sell to India, they could establish themselves as an arms supplier in other third world countries. Today, to get a foothold in the arms trade Russians need to establish that they are a reliable supplier of quality components and spare parts and uninterrupted servicing of Russian equipment can be done. Malaysian service contract of MiG29 fighter planes to India illustrates the need of reliable after sales service. Incidentally, these planes have American avionics and servicing technicians would have to get used to American technology as well.

6. Labour

In the post-liberalisation phase workers as well as society in general are disillusioned with unions because they have not come up with new approaches for the changed times. Unions must do some strategic thinking and organising if they are not to be made irrelevant. Keeping in line with the world trends Indian trade unions are also facing set back as there is a heightened concern among workers - white and black-collar - about their job security.

Union power seems to be waning. Keeping in line with the government's 'middle path', government does not want to be seen as reducing an individual to a unit of consumption and cost. But the government is finally getting its act together on the closure of sick public sector units. Prime Minister Rao has given green signal to go ahead with closure of unviable PSUs. More than 50 chronically PSUs have already been referred to the Board of Industrial and Financial Reconstruction and the latter has issued winding up notices in seven cases. Implementation of these orders is still awaited. The Finance Minister has been quoted as saying that 'death must be accepted as inevitable'.

It is believed that pace of reforms would slow down as state-run sectors such as telecommunications (470,000 workers) and banking (700,000 workers) are opened to foreign competition which would mean slashing payrolls. This is not true as both the sectors are set to expand hence, there is a shortage of skilled manpower at all the levels. As paraphrased in our earlier forecast some of the public sector companies have stopped voluntary retirement scheme as they have found that their skilled employees have taken voluntary retirement to join a private sector company. Though unions are not expected to support voluntary retirement scheme, they are not opposing it either.

According to the leaders of the HMS and Left Unions, significant industrial and economic changes have affected their membership in the past five years. According to them, ideological and other considerations had led to switching over of loyalties from one union to another. Hence, the unions have objected to the process of verification of membership pursued by the government on the basis of 1989 membership position. The report of the verification process has not been officially announced.

Government is not keen on setting up second Labour Commission which trade unions are demanding as it fears that it may interfere with the process of economic liberalisation. However, the Prime Minister has asked the Labour Ministry to frame the terms of reference in such a way that the Commission's view does not conflict with the changes the government is planning to make in the Industrial Disputes Act. There is a perceptible change in the attitude of trade unions. They are no longer opposed to mergers and amalgamations.

Probably labour has come to realise that some pain of restructuring is inescapable if Indian companies have to remain competitive and in that lies security of their jobs.

7. Conclusion

The money supply expansion in 1993-94 was brought about largely by the inflow of capital from abroad. To neutralise that expansion in money supply to rein in on inflation the conventional approach is not appropriate.

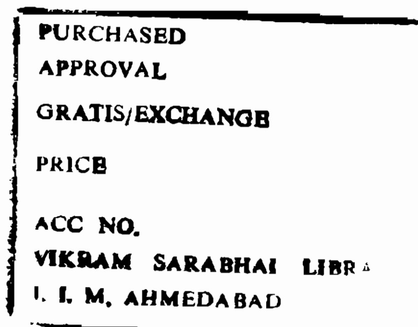
The government should take a bold step and reduce interest rates by another 2 to 3 percentage points. This would boost domestic investment, draw in imports and prick the ballooning foreign exchange reserves. It would also loosen the pressure on money supply and government deficit.

Prospects of a bumper *kharif* crop harvest are bright as rain god has been extra bountiful to the country. The government announcement about enhanced prices of

kharif crops gave a fillip to sowing. The prospects for cash crops are excellent. Several sectors like steel, automobiles, aluminium, textiles and cement are poised for a sizeable growth.

The RBI's target of $ 5 billion of foreign capital which it can manage by open market policy will be breached very soon and the bank would be forced to abandon open market operations and make a drastic change in its strategy. With a flow of $ 5 - $10 billion, the RBI would be able to manage with some major changes in the monetary policy but a flow greater than $ 10 billion would force the government to go for full convertibility in March 1995.

Union power seems to be waning. Keeping in line with the government's 'middle path', government does not want to be seen as reducing an individual to a unit of consumption and cost. But the government is finally getting its act together on the closure of sick public sector units. Prime Minister Rao has given green signal to go ahead with closure of unviable PSUs.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