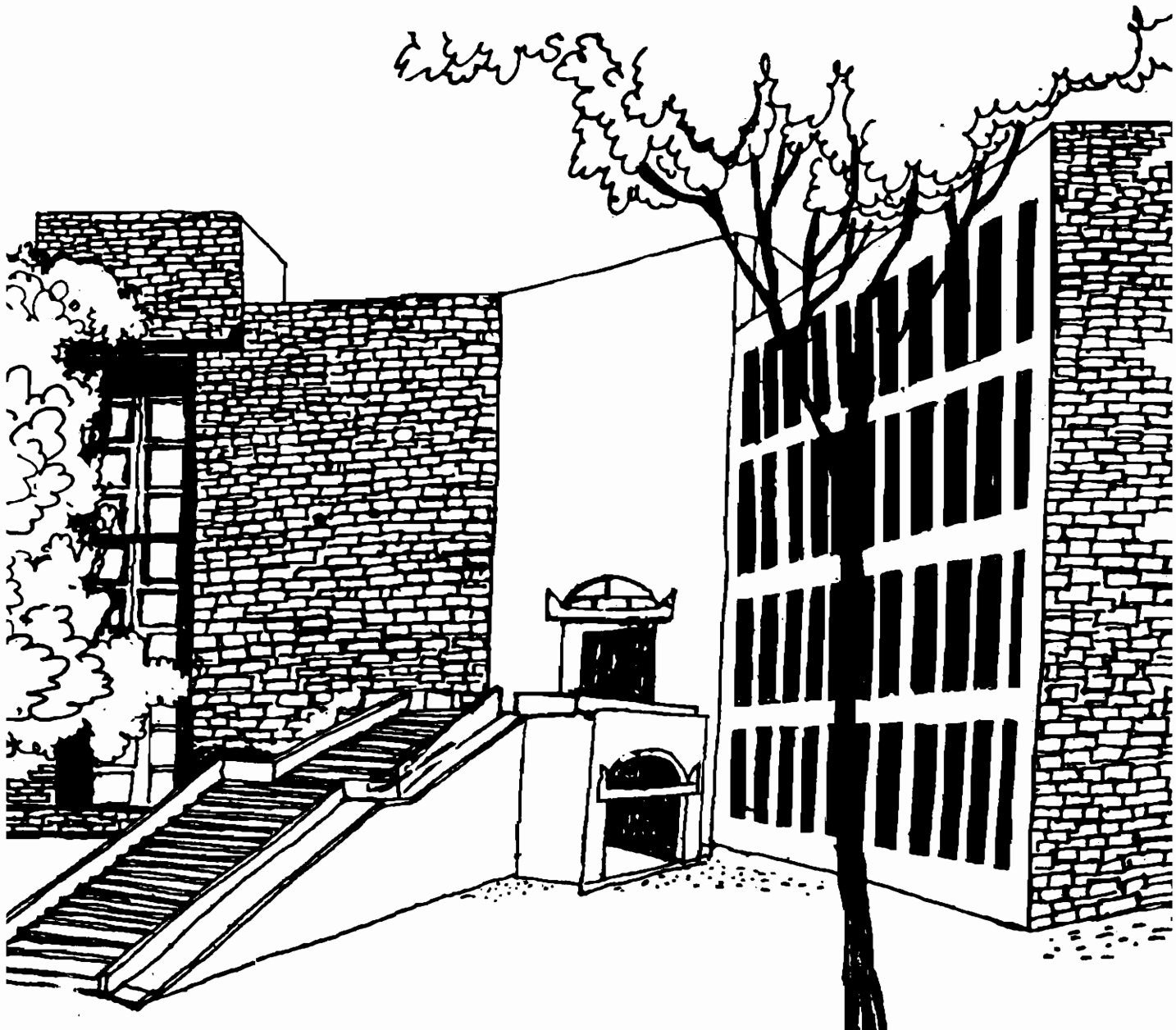




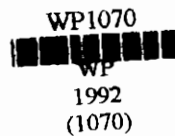
# Working Paper



**INDIAN ECONOMIC FORECAST  
NOVEMBER 1992**

By

A.B. Rastogi



W P No. 1070  
December 1992

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# **INDIAN ECONOMIC FORECAST : NOVEMBER 1992**

by

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## **ABSTRACT**

There are confusing signals which are being given by different ministers and their officials about the health of Indian economy. Among all this brouhaha attempt is made to give economic logic to events occurring around us and it is argued that the liberalisation process is very much on track. There is general sluggishness in the economy partly owing to hoarding by traders and slackness in domestic demand for consumer goods. The back of spiralling inflation has been broken and heat of competition is being felt in market place. The governments' credibility is at stake and hence in the coming budget we are not likely to see any hesitation or delay in implementing pre-announced reforms in trade sector, financial sector and industrial sector.

# INDIAN ECONOMIC FORECAST : NOVEMBER 1992

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## 1. Overview

There are confusing signals which are being given by different ministers and their officials about the health of Indian economy. Certain decisions like liberalisation of fertiliser prices is done on one hand, and the next week, subsidies are provided on other. Funding agencies are very optimistic about the pace of liberalisation process and economic press is full of loan proposals being considered by International Monetary Fund, World Bank and Asian Development Bank. On top of it certain liberalisation measures which were expected to have materialised like rupee convertibility on trade account have not been forthcoming. Markets have blown hot and cold over the convertibility issue in the past few months. Stock exchange indices are on a secular downward path and there are doubts about them holding at the pre 1992-93 budget level. Some commentators have argued that reform fatigue has set in and the reform program has lost sense of urgency. The reasons given are, first, because India has sufficient foreign exchange reserves, second, interest groups are hindering the reform process, third, the security scam and fourth, political will is missing to introduce reforms which are going to hurt powerful interest groups.

Among all this brouhaha attempt is made to give economic logic to events occurring around us and it is argued that the liberalisation process is very much on track. However, tactics of the government have changed as a result of different world scenario and domestic political constraints. Instead of being euphoric about the liberalisation process and raising the expectations of the people, attempt is being made to water down their apprehensions and expectations. In the second phase of liberalisation programme subsidies are going to be abolished and emphasis will be on achieving international competitiveness. A gradual process of change is in the offing rather than a cold turkey approach.

There is general sluggishness in the economy partly owing to hoarding by traders and slackness in domestic demand for consumer goods. The back of spiralling inflation has been broken and heat of competition is being felt in market place. The governments' credibility is at stake and hence in the coming budget we are not likely to see any hesitation or delay in implementing pre-announced reforms in trade sector, financial sector and industrial sector.

## 2. World Economy

Growth in the G7 nations during 1992 is likely to be around 1% for the second consecutive year. Upturn in 1993 is likely to be modest. The three major economies - the U.S., Germany and Japan - continue to be at different stages of the economic cycle. The uncertainties surrounding the world recovery is due to 'debt deflation' - i.e. the collapse in asset value of corporations and households relative to their heavily built up debt. The accompanying effects on bank net assets are a potent force in the US, the UK and Japan. Furthermore, slow domestic demand growth in all these economies means that recovery depends very heavily on the international economy. Short run real interest rates in the US and Japan are close to zero and it is falling rapidly in the UK as well.

The US has now had six consecutive quarters of positive growth after slowing down of the economy to a standstill at the end of 1991. The recent data suggest that almost similar is happening again. The economy has shown great reluctance to react to the major easing in interest rates which has taken place. The latest stutter in the recovery convinced the Fed to lower the discount rate to 3%. The Fed had expected credit growth to take place but it has not materialised yet. This had prompted the Fed Chairman Alan Greenspan to say that all methods to revive the economy have been tried but the economy is not responding favourably. The removal of electoral uncertainty, however, should improve business and consumer confidence now. A limited degree of fiscal relaxation could also provide a spur to growth. The week ended November 2 has shown some growth in M2 money supply suggesting an upturn in the economy in coming months.

The Japanese economy has been slowing for a while and the second half of 1992 is likely to see it in recession. The repeated easing of interest rates and a £54 billion fiscal package which had been announced earlier would have ensured that the Japanese economy picks up again sometime during 1993. But the political power struggle set off by the Tokyosagawa Kyubin has hindered the implementation of Japan's supplementary budget.

The German economy is presently close to a standstill. The continuing high interest rates and the likelihood of higher taxes means that there will not be a sustained upturn there until 1994. Investors in Germany are worried about serious recession developing and may be further exacerbated by the policy clash between the Bundesbank and the government and the continuing problems in the erstwhile East Germany.

Mr. John Major has said that final ratification of the Maastricht treaty would be delayed until after a second Danish referendum next May. This means 'Bye-Bye' to United Europe as Danes have requested for legally binding agreement on several key issues to reverse the rejection of Maastricht treaty in last June's referendum. The most important are a demand for a UK style opt out on a single European currency and exemption from putative European defence force. The latest news suggests that a patch up between London and Bonn has taken place. Chancellor Kohl is confident

that Britain would ratify the Maastricht treaty in the first half of 1993 but given the UK political and economic situation today it is virtually impossible. With the realignment of the Spanish peseta and the Portugese pescudo, the Exchange Rate Mechanism (ERM) is effectively a two tier exchange rate mechanism. Question is now being raised about whether the ERM will survive and in what form. In fact we can safely assume a free floating sterling pound for some time to come.

The Uruguay Round of trade talks have gained momentum after the US unlocked its horns with the European Community over agricultural subsidies. The prospects of the Uruguay round completed by February end, before the US administration's 'fast track' negotiation authority expires, are fifty-fifty. Bush would like the Round to get completed before he leaves the office in January 1993. Most of the deal is already agreed with just targets for farm subsidies to which the Frenchman does not agree. The French general election is due in March. At present the dilemma is that if the Socialist government gives in before the elections, they are likely to be out of the government. The French deputies have threatened to reject the Uruguay Round agreement and the French Prime Minister Beregovoy has called the agreement between the US and the European Commission as damaging to French farmers. Clearly the G7 economies are up against insurmountable interests which are poles apart and in a shrinking economic environment no one wants to dole out.

### **3. External Sector Cash Flow Management of Government of India**

It is the flux in the world economic environment which has compelled the government to be little pessimistic about their export promotion and bilateral aid from the G7 countries. The IMF and the World Bank recognize this and are therefore ready to play ball as long as they are assured that the adjustment programme is on track and ready to fill the financial gap which is likely to widen due to liberalisation process. These measures are going to help India in the long run and the world trade in immediate future.

The basic vulnerability of India's balance of payment (BoP) position has not yet been overcome. India's exports may have risen by 9% in June, 9% in July and 16% in August but it would be simplistic to expect them to accelerate in the next two years to a level which can assure foreign exchange availability to bridge the BoP gap. According to some analysts BoP deficit may rise from 3% of GDP to 5% of GDP in the next five years. Our model predicts a current account deficit of around 2.5% of GDP this year and around 2% in the medium term. The exceptional financing to the tune of \$5 billion per year for the next 5 years would mean that total foreign debt would be of the order of \$100 billion by 1997-98. The real damper is that India may put off or slow down the adjustment effort being daunted by these difficulties.

Government's media managers have successfully pulled the wool over the eyes of journalists about the IMF assistance. A casual reader of economic press may get a view that the Ministry of Finance has done a splendid job in getting loans from the WB/Fund. Table 1 helps to understand the intricacies of different types of facilities (loans) available to members of the IMF, repayment period, interest charged and conditions attached with each facility. The Fund/Bank are dead serious about the quarterly targets can be gauged from the fact that the Fund did not release the second tranche of the standby loan in July 1992 because India slipped in some crucial monetary targets and a new letter of intent had to be sent to the Fund in July 1992. However, the Fund released the information in such a way which would not embarrass the Indian government.

The IMF loan, so far, has enabled us to replenish our foreign exchange reserve and substitute the short term borrowing and also the dwindling NRI deposits. But there is still no sign of how we are likely to service the external debt that is going to mount as a result of the IMF borrowing being currently negotiated and which will become due for repayment from around 1994. The strategy is to use medium term IMF facilities accessible to low income developing countries at concessional rate. As India is committed to structural adjustment programme the quarterly performance targets can be achieved. Given the private sector enthusiasm for reforms, India would be able to meet all its obligations in the medium term. The portfolio of foreign debt after three years would be such that India could be on the path to liquidate some of its foreign debt. Therefore, the Finance Minister in an interview to the press has reiterated,

"it is our intention to convert the present standby arrangement with the IMF into an Extended Fund Facility arrangement to provide medium term BoP support for structural reforms".

### **3.1 World Bank SAL/SECAL**

The arithmetic of total aid (or exceptional financing needs!!) of \$7.2 billion pledged by the Aid India consortium for 1992-93 is as follows. \$3.4 billion out of this is fast disbursing loan to be provided by the IMF (\$1.6 billion standby loan), the World Bank (\$1.1 billion under structural adjustment loan (SAL)/ sectoral adjustment loan (SECAL), Asian development Bank (\$300 million under structural adjustment loan) and bi-lateral loans from Japan, Germany and the UK. Rest \$3.8 billion is pledged as bilateral aid tied to different projects.

India had been negotiating for two sectoral adjustment loans in 1992-93. One was for the financial sector and the other for the labour sector. Some key differences continue to persist over the implementation of financial sector reforms between government officials and the WB. These differences had been over expeditious steps on privatisation of banks and capital restructuring of banks. A broad agreement has been reached on funding an estimated \$500 million for National Renewal Fund during recent talks between government officials and a WB team. As fast disbursing



loan under the financial sector adjustment could not be provided by the Bank, it has identified a new sectoral adjustment programme for India to provide a fast disbursing loan during the current financial year in line with its pledge at the Aid India consortium last year. The new programme is linked to trade policy adjustment, which has either already taken place or is in the pipeline and is likely to be implemented on the Budget day 1993. Half of this sum as IBRD loan is to be repaid in twenty-five years time at the standard variable interest rate and other half as IDA credit with thirty five years maturity. The importance of these SAL/SECAL lies in the fact that the IMF board provides SAF facility to only those countries which have an on-going SAL/SECAL from the WB. Although the money given under these facilities is quite small, these loans/credits are given at a very low rate. One could almost say that these are giveaways

**Table 1: IMF Financing Facilities**

IMF/WB facilities	Duration	Repayment	Interest rate	Condition/Remarks
First credit tranche	One lump sum	3-5 yrs.	variable	Performance criteria is not required. Full repayment is to be done in one go. Basically to overcome bop difficulties.
Upper credit tranche (Standby agreement)	12-18 months	3-5 yrs.	variable	Quarterly performance criteria has to be agreed before the loan is given. Quarterly instalment is released only if the performance criteria is met.
Compensatory & Contingency Finance Facility (CCFF)			variable	No condition. To meet shortfall in export earnings for factors beyond the member's control
Extended Fund Facility (EFF)	3 yrs	4-10 yrs	variable	To achieve bop viability over the medium term. Performance criteria and loan in instalments
Structural adjustment facility (SAF)	3 yrs	5-10 yrs	concessional	For low-income developing countries to support in medium term macroeconomic and structural adjustment program. Member develops and updates, <i>with assistance of the Fund &amp; the Bank</i> , a medium term policy framework for a 3 year period in a policy framework paper (PFP). Annual loans and qtrly. bench-marks
Enhanced Structural Adjustment Facility (ESAF)	3yrs	5-10yrs	concessional	Same as for SAF. Difference relates to provisions for access, monitoring and funding. Generally more stringent than SAF

### **3.2 Extended Fund Facility of the IMF for India**

An agreement on Extended Fund Facility (EFF) is likely to be concluded by May 1993. The EFF for a 3 year medium term adjustment programme will include \$1 billion of soft loan under the Enhanced Structural Adjustment Facility (ESAF). The total quantum of EFF loan will be known in March 1993 when an IMF team comes to India to finalise the programme. It is expected that the IMF board will take a favourable decision in May 1993 facilitating continuation of IMF loan soon after the current standby programme ends in June 1993. A broad understanding to this effect has already been reached. There was also an exchange of views on what should be the content of India's policy framework paper required to be submitted to the IMF team in March next for the ESAF. It was hinted that the policy framework paper will be first presented to parliament before being handed over to the IMF officials. The policy framework paper (PFP) presented to the parliament will not contain any specific details of any action plan for the proposed economic reforms. Total amount sought is \$5 billion under the 3 year programme (EFF) starting from the next financial year. In fact this is 125% of the IMF quota allocated to India and this is the maximum amount India can draw from the IMF under 'normal' circumstances.

### **4. Budget 1992-93**

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It is the shock which Indian polity got last year from the international banking community that the political will is strong to continue with the economic reform process. Keeping this in mind and the pledges already given to the multilateral funding agencies one can safely expect a budget full of economic reforms and some hints about what can be expected in the medium term (i.e. in the next three years) which will form the backbone of the PFP going to be submitted to the IMF for EFF/ESAF loan. This is in line with the World Bank president Mr. Preston's affirmation that political commitment to reform and the reform program is right on track. The finance secretary warning to the business community that it should not expect any major and wide ranging tax concession and reliefs in the coming budget should be seen in the light that the coming budget is not a 'cut and run' type of budget. It is basically to reform tax structure and initiate reforms in trade and financial sector to make the economy competitive.

#### **4.1 Tax Reforms**

The Chelliah committee report has recommended lowering of corporate tax on domestic companies from the present level of 51.75% to 45% in 1993-94 by abolishing the surcharge and further

reducing it to 40% in 1994-95. The report recommends depreciation rate to be maintained at 25%. The buoyancy in tax revenue and better tax compliance may allow the finance minister to take a leap forward and reduce the corporate tax rate to 40% in one go. This is based on the following reasons. First, income & corporate tax collection rose from Rs 3376 crore during the first six months of the last financial year to Rs 6102 crore in April-September this year. Second, reduction in the corporate tax rate shall give boost to sagging bottom line of some industries. Third, as economy expands tax rates can be brought down without loss in gross revenue collection. Fourth, not all large companies pay the top rate here. Out of 2000 listed companies on the Bombay Stock Exchange only 47% paid taxes and that too on average rate of 32% of their profits. This contributes to only 31% of the total corporation tax collected. Hence, it is unlikely that a sharp drop in corporate tax is going to bring down gross revenue collection as corporate tax contributes roughly 10% of gross tax collection only.

Government has been moving from *ad valorem* to specific rates of central excise duty without losing revenue in the past. It has made the tax administration simple and has been a boon to manufacturing industries as few assessment disputes arise from *ad valorem* duties. As central excise duty is roughly 45% of overall tax collection, the changes in excise duties may not be revenue neutral as government is likely to lose some revenue from custom duties. Having reduced the corporate tax substantially the government would like to claw back some of it through excise channel.

A large reduction in custom duties is expected but as it contributes roughly 34% of overall tax collection it is more than likely that government would lose some taxes from the changes in the custom duties. No doubt that reduction in custom duties shall increase imports but it would contribute to the revenue which government will forgo due to reduction in custom duties. Basic income tax structure in all probability would be indexed in line with inflation rate at least. Taxation of agricultural income is not likely to be taken up in this budget.

To attract foreign investment the government is inclined to reduce the tax rate on short-term capital gains for foreign institutional investors, which is 65% at present, to 50% or even lower to bring it in line with our competitors for funds like Malaysia, Indonesia and Thailand.

## **4.2 Trade & Exchange rate Reforms**

It seems that the view of the commerce ministry diverges from that of the finance ministry on custom duties and rupee convertibility on trade account. The commerce ministry would like to see custom duties to be brought down slowly to protect domestic producers and to have rupee convertible on the trade account to give exporters benefit of rupee devaluation of roughly 12%-15%. The liberalised exchange rate mechanism system (LERMS) has taxed exporters roughly 7%.

According to news reports the Finance Minister has hinted to the IMF team in early November that rupee convertibility can be tackled at the budget time. There are good chances of this happening as it is imperative to end the dual exchange rate system. It shall be in line with the government promise that when fiscal deficit and inflation are under control the rupee will be made convertible on trade account. By Mid-February inflation would be around 8% and foreign exchange reserve would be about \$6 billion or so. This reform would go down well in the markets too as they are expecting this.

### **4.3 Financial Sector Reforms**

The Financial sector reforms as sketched by the Narsimhan Committee, the Nadkarni Committee and the Shah Committee reports have been endorsed by the Cabinet Committee of Political Affairs and expected to be implemented in 3-4 years' time in phased manner as suggested in the latest World Bank country report and reiterated by the Finance Minister. The Asian Development Bank loan of \$300 million to meet capital adequacy norms of banks in this financial year is the first step in this direction. As government can contribute only a limited amount and in March 1993 first time banks' balance sheets according to new format will be available, the government is likely to choose the path of raising some equity from the market. This shall go a long way in satisfying the IMF/WB requirement without alarming bank unions. Of course, legislation to this effect has to be brought in the parliament before going to the market. The financial sector reforms brought about in the Budget would show a firm resolve of the government to make the financial sector competitive and influence the IMF in sanctioning an Extended Fund Facility to India.

Statutory Liquidity Ratio (SLR) is to be gradually reduced so that banks can lend more at market related interest rates. Further, reduction in interest rates is also on the cards. More competition from private sector banks and adequate provisions for non-performing assets is likely to be taken up in the budget.

Financial sector companies other than banks and insurance companies may get a stiff dose of competition as 51% foreign stake is expected to be permitted in service sector companies in the coming budget. This shall be in line with the World Bank country report which has suggested that efforts to attract foreign investment need to be strengthened. SEBI may be given further powers to regulate capital markets and stock exchanges.

## **4.4 Labour Sector Reforms**

The labour sector reforms like in all other countries is a very touchy subject. Nascent social safety net has become operational in November 1992. It was a much awaited reform but it was announced without fanfare and hardly any publicity was given to it. The government, because of political compulsion, is of the view that flexibility in the labour market will be socially and politically acceptable in an expanding economy rather than in a stagnant economy. The World Bank which has given a sectoral adjustment loan of \$500 million to contribute to National Renewal Fund (NRF), according to its President is willing to give India latitude in phasing reforms in order to improve their sustainability.

## **5. Forecast**

The present forecast (table 2 and table 3) 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.

## **6. Exogenous variables**

### **6.1 World Interest Rates**

To revive their economies the US and Japan have cut their interest rates drastically. There had been a sharp fall in the UK rates as well in the last quarter. Keeping this in mind the real short-term and real long-term interest rates have been revised downward.

### **6.2 World Trade**

As outlined earlier there is a major doubt about the pick up in the industrial economies. The Commonwealth of Independent States and other East European states too are not in a position to give hope of world trade recovery. Therefore, world trade growth has been revised downward in 1992 and expected to grow almost half of the underlying growth rate in 1993 before returning to normal growth rate in 1994 and 1995.

**Table 2: Exogenous Variables**

	1990	1991	1992	1993	1994	1995
<b>World</b>						
Trade growth (%)	4.0	1.5	1.3	2.8	5.6	5.5
Real Short-term Interest Rate	4.0	3.1	2.0	3.0	3.2	3.2
Real Long-term Interest Rate	5.7	5.4	4.5	4.0	3.5	3.5
O.E.C.D. Inflation	4.5	4.3	3.0	3.0	2.9	2.9
Crude Oil(\$/barrel)	18.0	20.0	19.0	19.0	19.0	19.0
<b>Domestic</b>						
	90-91	91-92	92-93	93-94	94-95	95-96
Rainfall (% of normal rainfall)	106	92	100	100	100	100

**Table 3: Forecast**

	90-91	91-92	92-93	93-94	94-95	95-96
GDP growth (%)	5.6	1.6	3.1	4.1	6.0	5.9
WPI (%)	12.1	12.8	9.5	7.0	6.5	6.0
CPI (%)	13.6	13.9	12.5	8.0	7.0	6.5
Exports (%GDP)	6.2	7.2	8.2	8.6	8.9	9.1
Imports (%GDP)	8.2	7.8	10.0	10.2	10.3	10.2
Current a/c (%GDP)	-2.5	-1.0	-2.5	-2.2	-2.0	-1.8
Current a/c (\$ bill)	-9.9	-3.0	-5.9	-4.6	-3.4	-3.2
Capital a/c (\$ bill)	-3.0	-3.0	-3.3	-4.0	-4.5	-5.0
(principal repayment)						
Exchange Rate (Rs/\$)	18.2	24.5	30.5	31.5	33.6	34.6
(open market, nominal)						
Production (growth p.a.):						
Agriculture	3.2	-1.0	3.0	2.1	2.2	2.2
Non-agriculture	7.0	2.8	3.2	5.0	8.0	8.0
Investment (% gdp):						
Private Sector	14.0	12.5	13.2	14.7	15.5	15.2
Public Sector	10.5	10.5	9.5	8.7	8.4	8.4
Govt. expdt. (%gdp)	32.0	30.3	30.2	29.7	29.6	29.5
(Central + State + UTs)						
Central govt. deficit (%gdp)	9.0	6.3	5.0	4.0	4.0	4.0

### 6.3 Oil Prices

The OPEC meeting concluded in the last week of November in Vienna discussed the thorny topic of members' output quota and how to deal with eventual return of Iraq to the export market. They have agreed on enough production cuts to balance supply with demand. In the developing countries the demand for crude oil is not likely to pick up in winter months too. The price of a barrel of crude

oil increased a paltry 20 cents indicating that traders are not convinced that OPEC members would adhere to production cuts.

The OPEC allowed downgrading the membership of Ecuador (1.3% of total OPEC output) to associate membership because Ecuador feels that she cannot afford membership fee and her interest would be better served outside OPEC, as the organisation has failed to raise prices. If bigger members like Nigeria and Venezuela could also be tempted to follow Ecuador, this could pose a threat to OPEC.

## **6.4 Domestic Rainfall**

No change has been made in the domestic rainfall assumption.

## **7. Output**

Optimism of government and of some forecasters suggests that the economy is moving ahead and would be running at full throttle before the next budget itself. Industrial production figures, pessimism among producers, especially small scale producers and medium scale producers, do not support this optimism. If anything, it points in the direction of the worsening of total output. However, situation is not so bad. Leading and concurrent macroeconomic indicators like tax collection, railway freight movement, power generation do not corroborate producers pessimism for the next quarter. Our forecast of total output for this year remains almost the same as it was in the last report at around 3% level.

### **7.1 Agricultural Output**

*Kharif* production is estimated to be in the region of 100.6 million tonnes with a bumper coarse cereals and oilseeds production as predicted in the last report. *Rabi* season sowing is in full swing and despite increase in the fertiliser prices etc. farmers have reduced the consumption of phosphatic fertilisers as much as 30% to 40% according to fertiliser traders. They are substituting phosphatic fertilisers by other nutrients like calcium and ammonium sulphate. Furthermore, they are using green manure to improve the yield. Traders in main food growing area expect that *rabi* crop of foodgrains and sugar-cane would not meet its target output and food-grain prices would shoot up in summer 1993. Their expectations will not materialise as area sown under food-grains is

approximately 5% higher than that of last year. However, farmers expect better prices for their produce. Having burnt their fingers last year farmers are unlikely to carry stocks again in 1993. Winter rains have further improved the prospects of *rabi* production. *Rabi* crop production is expected to be around 80 million tonnes, thus giving an overall 3% growth in the agricultural production this year.

The Commission on Agricultural Cost and Prices suggested procurement price of wheat at Rs. 305 per quintal this year, which is nearer to the open market prices of Rs.311-Rs.325 per quintal in Punjab and Haryana prevailing in the last quarter. The rise in fertiliser prices has had minimum cost impact of around Rs.10 per quintal after taking into consideration the reversal in the fertiliser subsidies. A 27% rise in the procurement prices has aided speculation that procurement price may rise as it was done last year by giving almost Rs.35 per quintal extra by the state governments to boost the procurement. This will not come true this year as government is importing wheat to replenish its food stocks and the Finance Minister has warned the state governments to live within their means and not to expect automatic over-draft facility from the RBI. This is likely to keep food prices in check in the open market and shall not fan consumer price index in the coming quarter. Agricultural output in the medium term is expected to grow by little over 2%.

## **7.2 Non-Agricultural Output**

Non-Agricultural output is showing an upward trend. In the first quarter of 1992-93 industrial production increased by 2.2% but the monthly production figures were erratic. As industries are going through major expansion and gearing up for an enhanced competitive environment, the industrial output will increase slowly and steadily. The domestic production for consumer goods, both durables and non-durables, is in recession but that of basic industries like fertilizers, cement, metal and electricity is sluggish. Between April-June 1992 production increased by 1.5% in basic industries and capital & intermediate goods production rose by over 7% in the same period.

The domestic demand of manufactured products is slack. In volume terms it is expanding at a rate of 2%-2.5% only. As government has postponed its capital investment plans, capital goods industry is facing lack of demand. Coupled with this non-payment of bills by the government has given rise to liquidity problems for fertiliser industry and other industries.

Service sector output which showed a phenomenal increase last year would also be down but still it should be able to notch up around 4.5% growth this year; a large part of this growth has been contributed by heightened activity at the beginning of current financial year. Between April-June 1992 overall production was 3%. Overall non-agricultural output is expected to be around 3.2% in this fiscal year. Next year it is expected to rise to 5% and thereafter around 8% in the medium term.



## 8. Interest Rates and Credit

The busy season credit policy in October 1992 saw a reduction in interest rates by 1% across the board and a gradual reduction in SLR which has enhanced the stock of loanable funds with banks. Following a reduction by half a percentage point in the lending rate to financial institution by Unit Trust of India and Life Insurance Corporations of India the ceiling on lending rate by financial institutions has been brought down from 20% to 19%, but it is not lowered across the board and will be decided case by case. However, top rated companies stand to benefit from this move.

As part of on-going financial restructuring government is committed to bring down SLR and CRR further. This time again one to one and a half percent cut in SLR is expected which shall boost loanable funds with banks even further. There are strong economic reasons like reduction in inflation and increased supply of loanable funds which call for reduction in interest rates. The government can be bold and reduce the interest rate by 2% but given the returns on 364 days treasury bills prevailing now around 11.3%, government would be cautious. However, 1% cut can be expected either in the budget or in the lean season credit policy going to be announced in March 1993.

Bank credit to commercial sector has increased which is another indicator of inventory pile up and increase in receivables. RBI credit to government has reduced in this fiscal year but bank credit to government has increased as banks are investing in treasury bills to have a cover for their future expected liabilities coming from non-performing assets.

## 9. Inflation

Some analysts have argued that data on inflation is being 'cooked' by the Ministry of Finance to be in line with the end year inflation target. Also reference is made to the gap which is emerging between the provisional figures and final figures. It is disconcerting but there is hardly anything one can do about official terminal inexactitudes. Official explanation is that it is due to delays in data collection and hence, when prices are rising, quick official valuation underestimates an actual increase in prices.

The reason why the CPI is higher than the WPI is because the weights given to foodgrains in the latter index is lower and the price of foodgrains has been rising faster than that of manufactured products mainly due to higher procurement prices and increase in input prices like fertilizers and

electricity. But the trend has reversed in the last six weeks. Prices of manufactured products have pushed up due to cost push factors and prices of essential commodities have been falling. The economy seems to have digested the increase in prices of petroleum products; annualised WPI figure in October was about 10% which has come down to 8.8% for the week ended November 14.

The reasons for downward pressure in primary goods market are as follows. First, hoarding done by farmer-traders in anticipation of increase in prices as a result of shortfall in agricultural production has not materialised. Off-loading of that hoarding has increased supply of primary articles in markets. Second, traders and households are short of liquidity as many have lost their savings in stock market crash through fly-by-night operators in towns and cities. They have also lost their savings in other scandalous financial schemes like chit-funds, lotteries. Therefore, spiralling price expectations are taking a severe beating now and are likely to remain on hold in the next fiscal year too. The deregulation of coal prices may put little pressure on prices after the budget. For now it seems that the cost push factors are unlikely to exert any burden on prices in the next quarter.

One has to watch for an increase in prices again when rupee is made convertible on the trade account and the POL imports are done at the open exchange rate and consumers start paying market rate of petroleum products. A gradual move towards market determined retail prices is likely to be followed so that economy does not suffer from the indigestion of social unrest and short-term and short sighted political gains.

## **10. Exchange Rate**

As mentioned earlier rupee convertibility on trade account is being looked at differently by the Ministry of Finance from the Ministry of Commerce. However, there are good indications and number of economic and non-economic compulsions to believe that the rupee convertibility shall be announced in the 1993-94 budget. These are, first, to give boost to export growth exporters need a further injection of price competitiveness in terms of effective devaluation of rupee of roughly 15%-17%. Second, rupee has appreciated about 9%-10% in the last one year and an extra price competitiveness of 5%-7% in rupee term shall give required leeway to penetrate in the sluggish export markets.

Forward premium in the exchange market is prevailing around 20% for some time now which is likely to increase further nearer to the Budget time but may fall sharply after the announcement. The downside risk of rupee convertibility is increase in domestic inflation, but this would very much depend on whether the price of petroleum products is allowed to be determined freely. A cautious approach is likely to be taken in this direction using the float available under the oil pool facility.

## 11. Trade Balance

The current fiscal and monetary squeeze combined with devaluation is bearing fruits now. Non-oil imports increased by only 14.6% in April-August this year, which is lower in absolute terms compared with two years ago. It is the increase in oil imports by 45.8% in April-August which has made a gaping hole in the trade balance. This increase is a direct result of the fall in the ONGC production. Overall trade deficit during the first five months of 1992-93 increased to \$2.3 billion against \$919 million in 1991-92. This should not be alarming as 1991-92 was an exceptionally different year for imports. Overall trade deficit in 1992-93 is expected to be around \$6 billion.

The export target of \$20 billion for 1992-93 is attainable, but the key is to restore export profitability in short term. It is widely believed that the exports are going to accelerate in the long term as most of the companies are preparing themselves for export markets. A liberal import regime seems necessary to allow industry to modernise if it is to achieve further export competitiveness and meet their competitors on the home turf. There lies the dilemma. The Commerce Ministry thinks that domestic producers must be protected by keeping high tariff walls, but that would also mean that fledgling exporters would not be allowed to become strong on the home ground itself. What is required is a bit of a Spartan heart and allow the fledglings to face rough weather here.

## 12. Public Finance

Having burnt their fingers in June 1992 about not meeting the prescribed quarterly target the central government expenditure is being closely watched. Thanks to the RBI ban on ready forward transactions and a yield of 11.3% on 364 days treasury bills, this money market instrument is in heavy demand. The effect of this on government finances is that they have deferred this year's payment to the next year. If there is a surge in the economic activity next year, it would not be difficult to roll over this debt forward. The fiscal compression this way is far milder than it would have been otherwise. However, the net RBI credit to the Centre has reduced. The total outstanding credit for this year fell short of the end-September stipulated target of Rs. 99,900 crores. Most likely the government is likely to meet the end year target comfortably. The bond-financed fiscal deficit is certainly less inflationary than the money-financed one as long as prudent fiscal measures are taken when the economy is growing with a long term aim to lower the fiscal deficit not more than underlying rate of growth of the economy.

Tax revenue had been buoyant in the first half of the year largely due to tax compliance and advance tax payments. This may not continue in the second half of the year as corporate sector performance is declining. This implies that government would have to meet part of its budget deficit by selling bonds.

### **13. Investment**

Any upturn in confidence is likely to have only a lagged effect on investment. Gross domestic fixed capital investment is expected to remain at the last year's level in real terms. On the basis of project disbursement by all India financial institutions RBI predicts 11% growth in real terms in *corporate* investment. Rights issues which are flooding the market are not backed by new projects or investments. A preliminary analysis suggests that corporate sector wants to reduce the effective cost of fund by raising equity and change the mix of financial needs in the long-run.

Market is generally perceived by the foreign investor as over-valued at profit to earning ratio of thirty-two. Sustainable profit to earning ratio is 20/22, which is likely to be achieved by the budget time. Corporate earnings are not expected to rise dramatically before March 1994, partly due to announced changes in corporate tax structure and partly as a result of lower domestic demand.

### **14. Labour**

Without much ado the decision was taken to put much awaited National Renewal Fund (NRF) for the retraining and rehabilitation of displaced workers of the sick industrial units. This is the first clear signal to implement the exit policy. The fund will be operated by a committee. The fund consists of the National Renewal Grant Fund (NRGF) and the Employment Generation Fund (EGF). The NRGF will deal with the immediate requirement of labour in sick units and the EGF will provide resources for approved employment generation schemes, both for organised sector and unorganised sectors. This meets the Indian industry and prospective investors demand half way as it does not provide full freedom to hire and fire and to close down a unit.

The government has provided Rs 200 crore for NRF in 1992-93 budget and another Rs. 1000 crore from the proceeds of PSU disinvestment. An amount of \$500 million is going to be released by November end by the World Bank under its sectoral adjustment loan for the NRF. USAID is also expected to contribute \$175 million to this fund.

The private sector is not quite satisfied with the scheme. They would like it to permit closure of unviable units in the private sector too to get the best out of NRF. They would like their apex organisations to be associated with the administration of the Fund.

Some progress has been made in retraining textile mill workers in Ahmedabad, Bombay, Calcutta, Kanpur and Indore. These programmes are run by employee rehabilitation centres. The government and industry associations want to further it by having registration offices for those who would like to be retrained. There is a plan to introduce an insurance scheme at a later stage. It is expected that roughly 100,000 workers would have opted for some kind of voluntary retirement scheme by March 1992.

## **15. Summary**

The halting recovery in the G7 countries and a very slow growth in the world trade have given rise to the possibilities of BoP difficulties in the medium term for India. To ensure the success of the on-going economic reforms tactical changes have been made to overcome the BoP difficulties in the medium term. To mollify the fears of interest groups within the ruling party and to lower the rising expectations of the people a low key approach to announcements and expected results from the reform programme is being taken. Nevertheless, the economic reforms to make the economy competitive are very much on the track and unlikely to fizzle out. Some major changes in all the sectors of the economy are expected in the Budget 1993-94. The growth prospect next year is forecasted to be better than this year and in the medium term it is expected to be about 6% on average.

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