

# Economic reform is set to continue in India but at only a modest pace in the foreseeable future

*The new Congress party-led government has set ambitious goals and is aiming for real GDP growth of 7-8% per annum over the medium term. It recognises that this will require further economic liberalisation, but only slow progress is likely over the next couple of years due to political constraints. India's growing importance in an integrating global economy is unlikely to be derailed.*

## **The Congress-led coalition is politically-diverse and dependent on communist support**

Following the surprising result in India's general election in mid-May, and Sonia Gandhi's decision not to serve as Prime Minister, there was a smooth transfer of power from the BJP-led coalition to the Congress-led coalition of Prime Minister Manmohan Singh. Congress won 145 seats out of a total of 545 in the lower house of parliament (Lok Sabha) and its United Progressive Alliance (UPA) of 12 political parties has a total of 221 seats. This is short of a majority, but the UPA is supported from outside the government by the Left Front parties, with about 63 seats, which provides it with the necessary parliamentary support.

It is too early to predict the durability of the UPA coalition or the support from the Left Front parties. But an early election seems unlikely, as it could provide an early opportunity for the BJP to return to power. Congress itself would probably be the main beneficiary at the expense of its allies if they were judged to have not given it a reasonable chance to pursue its objectives. Political uncertainties are exacerbated by concerns about whether Congress has the flexibility to co-operate with regional political allies that do not share its culture of centralisation. It is not yet clear whether Prime Minister Singh has the authority and vision to provide strong political leadership or whether the dual leadership of Mrs Gandhi, as leader of the Congress party, and Prime Minister Singh will withstand the big challenges that lie ahead.

## **The new government's objectives are ambitious and far-reaching**

The broad objectives of the new government were set out in its 'Common Minimum Programme'. The programme is wide-ranging and reflects the political priorities of the Congress party and its allies. The main emphasis is on improving living standards for the large rural population by increasing public and private investment in rural infrastructure and irrigation, doubling the availability of rural credit within three years, improving agricultural research and support services, promoting crop diversification, and creating a national market for farm produce. Public works programmes will provide a minimum 100 days' employment for every rural household at

the minimum wage. The focus on agriculture is positive because its importance for employment and consumer spending is such that strong performance in this sector has a significant knock-on effect for manufacturing and other sectors of the economy.

In the broader economic arena, the main priorities include annual economic growth of 7-8%, which the government recognises will require further economic liberalisation and additional investment in infrastructure. The government intends to reduce the fiscal deficit, and seek increased foreign investment in technology, services and export-based industries. The influence of the communist parties is evident in a much more cautious approach to privatisation with the government ruling out the sale of majority stakes in profitable state-owned enterprises, and in undertaking not to make changes to labour laws that would make it easier for employers to hire and fire workers despite recognising the need for greater labour market flexibility. The government will review the 2003 liberalisation of the electricity sector, but recognises the need to attract private investment to develop power-distribution capabilities. There are also commitments to strengthening the legal system to prevent violence against minorities, improving the parliamentary representation of women, and doubling spending on education to 6% of GDP.

In foreign affairs there are no significant changes from the policies pursued by the BJP coalition. India will pursue peace talks with Pakistan and will work towards resolving conflicts in Sri Lanka and Nepal.

The programme has attracted criticism for being optimistic, over-ambitious, superficial, idealistic, vague, contradictory, and so on. While much of this criticism may well turn out to be valid, it ignores the reality of a compromise that takes account of the platform on which Congress fought the election, the election result, the broad political spectrum encompassed by Congress and its allies, and the complexities of trying to meet the needs of a democracy as large and diverse as India's.

Alongside some criticism of the government's ambitious political agenda, there is also a much more realistic appreciation of the constraints and

difficulties that it faces in balancing its own diverse political objectives and meeting electoral expectations. The new government recognises the aspirations of the population for improved living standards, but is also committed to tackling entrenched economic problems, such as the large budget deficit, and extending economic reforms to encourage increase private sector investment by both domestic and foreign companies. Further economic liberalisation offers the best prospect of boosting economic growth and raising living standards over the medium term, but Congress is well aware of the specific and pressing needs of the large rural sector. The surprise election result, which is widely regarded as a consequence of the recent economic boom being largely confined to upper-income earners, should itself ensure that these needs are not neglected.

There is widespread confidence in the strong economic and reformist credentials of both Prime Minister Singh and Finance Minister P. Chidambaram. Manmohan Singh, as finance minister, was the inspiration behind the economic liberalisation of the early 1990s when India faced acute economic difficulties including severe balance of payments problems. He is widely admired within India and internationally for his integrity and intellect. The reform process was deepened and broadened during P. Chidambaram's tenure as finance minister in the mid-1990s; he has a strong economic background and first-hand experience of coping with diverse political pressures and vested interests.

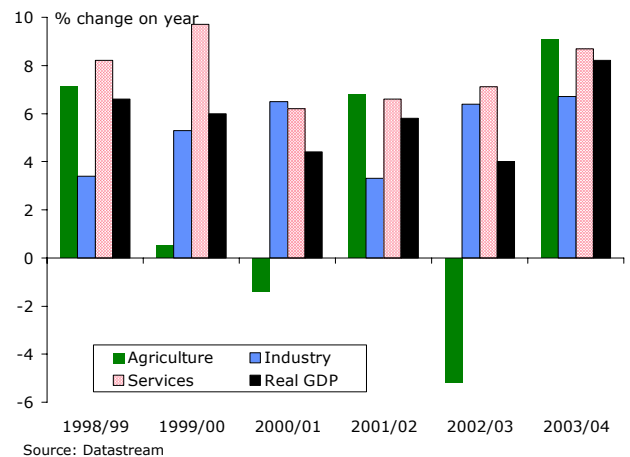
### The economy rebounded in 2003/04

Real GDP rose by 8.2% in fiscal year 2003/04, double the 4.1% rise in 2002/03 and the strongest annual increase since 1988/89. While the economic reforms introduced in recent years by the BJP-led government have had a positive impact in raising the sustainable pace of GDP growth, it is important to recognise that strong economic performance in 2003/04 was, to a significant extent, due to a rebound in agricultural production following the sharp decline in 2002/03 caused by bad weather. Agricultural output rose by 9.1% in 2003/04, in marked contrast to a 5.2% contraction in 2002/03. However, while this strong recovery was a significant factor behind the overall rise, it was by no means the only one. The recovery was broadly-based with the industrial sector expanding by 6.7% in 2003/04, a modest improvement on growth of 6.4% in 2002/03, and the services sectors growing by an impressive 8.7% in 2003/04, a clear improvement on growth of 7.1% in 2002/03.

Quarterly GDP figures also show growth of 8.2% in the year to Q1 2004, down from 10.5% in Q4

2003. The slowdown mainly reflected a dip in the surging growth of agricultural production from 16.5% to 10.5% over this period.

### Agriculture boosts GDP growth in 2003/04



### The large fiscal deficit continues to hamper economic growth

One of the biggest challenges facing the government, that its predecessors have made only modest progress in tackling, is the weak fiscal position. Federal government revenue is equivalent to less than 10% of GDP (total tax revenue is around 15% of GDP), well below that of most other Asian countries. There is an urgent need for a significant reallocation of spending from defence, debt service, and subsidies that primarily benefit the middle classes, to expenditure on infrastructure, education and health, that would improve living standards directly and provide a basis for faster economic growth in the future.

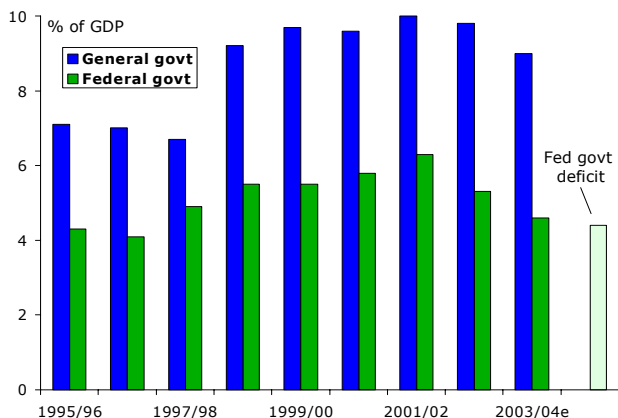
The general government fiscal deficit, which includes state and local governments, has been close to 10% of GDP over recent years. With a low level of domestic savings, recurring public sector deficits of this magnitude have a detrimental impact on domestic interest rates and crowd-out private sector investment.

### The 2004/05 budget balances economic reform and political realities

The central government fiscal deficit narrowed to 4.6% of GDP in 2003/04, from 5.3% in 2002/03, with tax revenues benefiting from the strong economic recovery. The federal budget for 2004/05, unveiled by Finance Minister Chidambaram on 8 July, envisages a modest reduction in the deficit to 4.4% of GDP and reiterates the commitment to GDP growth of 7-8% per annum over the medium term. The 'revenue deficit', the gap between tax revenue and current

spending, is to be cut from 3.6% of GDP in 2003/04 to 2.5% in 2004/05, while a 5-year 'road-map' focuses on eliminating the deficit by March 2009. As expected, a major thrust of the budget is on the rural sector and on strengthening infrastructure.

### Fiscal deficits narrowed modestly in 2003/04



Sources: Institute of International Finance, Indian Ministry of Finance

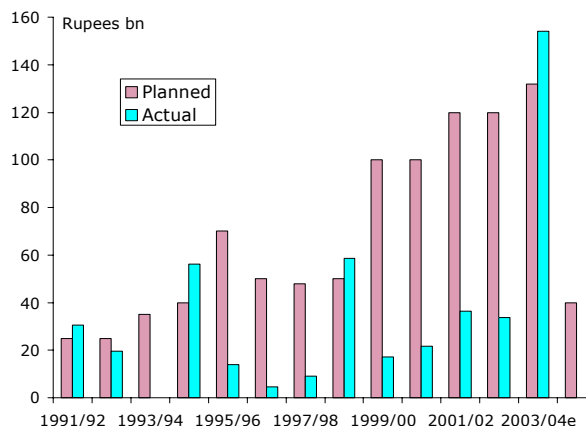
The budget contained a series of tax measures. Surcharges of 2.0% on both direct and indirect taxes are designed to fund additional spending on education. A transaction tax of 0.15% has been imposed on securities trade, but short-term capital gains tax was halved to 10% and long-term capital gains tax has been abolished. The service tax rate has been raised from 8% to 10% and the range of services to which the tax is applied has been broadened. A value-added tax system will be introduced by April 2005, a long-awaited step that the BJP was unwilling to take because of opposition from small traders and retailers that provided electoral support.

According to the budget, limits on direct foreign investment will be raised in a number of important sectors. The limit on FDI has been raised from 26% to 49% in insurance, from 40% to 49% in aviation, and from 49% to 74% in telecoms. Prime Minister Singh recognises the important role of foreign investment in boosting development and raising the pace of economic growth. The decision of the government's communist allies to oppose the planned increases in FDI limits is disappointing although they apparently do not intend to try to bring the government down over this issue. There is also concern about ideas, rather vague at this stage, that the government could require companies to meet job quotas for workers from economically-disadvantaged sections of society.

Privatisation proceeds totalled INR154 bn in 2003/04, exceeding the official target for the first time since 1998/99. However, a much more

cautious approach to privatisation is confirmed with the budget reducing the privatisation target for 2004/05 to INR40 bn. The privatisation of New Delhi and Mumbai airports is going ahead, but the government has cut the ceiling on foreign ownership from 74% to 49%. Several international groups have expressed interest in the airport privatisations and it seems unlikely that they will be deterred by the new restriction on ownership.

### Privatisation proceeds surged in 2003/04 but the new government is much more cautious



Source: Indian Ministry of Finance

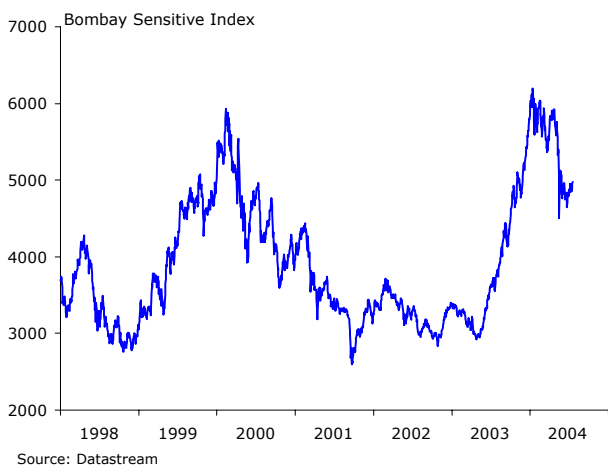
In addition to providing details of public finances in 2004/05, Finance Minister Chidambaram also put fiscal objectives in a medium-term context. The Fiscal Responsibility and Budget Management Act, approved in July, requires the government to reduce the Federal deficit by at least 0.3% per annum and the revenue deficit by at least 0.5% per annum. The problem of tax compliance is expected to be assisted by electronic advances in the tax department, which is bolstering confidence in the system, reducing opportunities for corruption, and is at least partly responsible for a sharp rise in the number of individual taxpayers over the past few years. A reduction in the large number of tax exemptions could have a significant impact in bolstering tax revenue, but progress in this area is still severely hampered by the strength of special interest lobby groups.

Overall reaction to the budget was cautious with a mildly positive reaction from many observers. There is broad recognition of the constraints facing the government in seeking to balance political realities against the expectations of the electorate, hoping for better living conditions, and financial markets, anxious to see a strong commitment to further economic reform.

While some analysts have commended the budget as being balanced and well-considered when set against this background, others have criticised it as

too populist in terms of the commitments to the rural sector. There are concerns that revenue projections are too optimistic and whether planned spending can be honoured without an adverse impact on the fiscal deficit. Some analysts expressed disappointment that measures to broaden the revenue base were not sufficiently far-reaching, and others were disappointed by the failure to cut the small savings interest rate, which remains well above market interest rates. Within the broad spread of reactions, others judged the current budget as merely a holding exercise and look forward to a much bolder and ambitious strategy when the next full-year budget is presented in February 2005.

**The stock market is worried about slower privatisation and economic reform**

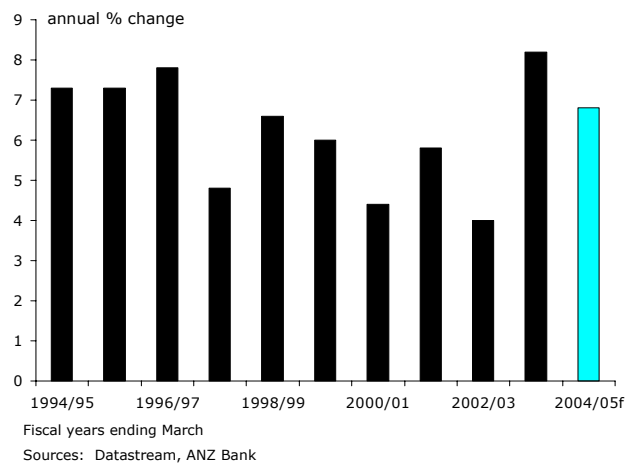


The stock market fell by 2.3% on budget day with the decline blamed on the introduction of a securities transactions tax. More broadly, the stock market has managed to claw back only a small proportion of the sharp losses suffered on 17 May, when the Bombay Sensitive Index fell by more than 11% on concerns about the future of economic reform following the surprise election result.

**Real GDP growth to slow in 2004/05**

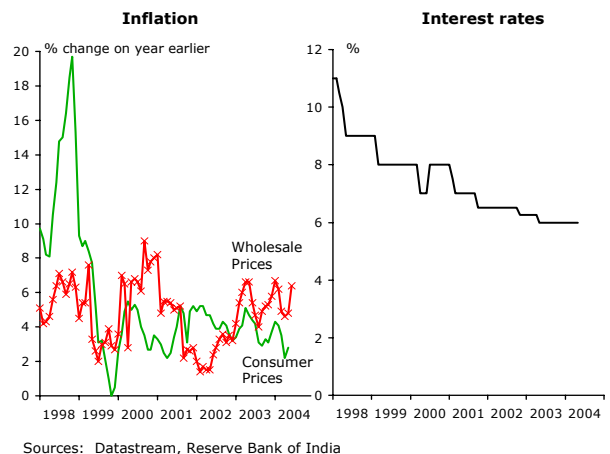
Real GDP growth is forecast to slow to 6.5-7.0% in 2004/05 on the assumption that agriculture expands at a more normal pace following last year's surge. However, in mid-July, there were growing concerns about the outlook for agriculture as forecasts of good monsoon rains were jolted by floods in parts of the country and fears of drought in other regions. Current economic growth projections also reflect the adverse impact of the current high level of international oil prices, and reduced prospects of a significant decline in oil prices in the short term.

**Real GDP growth**



The official medium-term inflation target is 4-5%, but inflation in the current financial year is expected to be 5-6%. While consumer price inflation was a modest 2.8% in the year to May, the authorities pay close attention to the wholesale price index which rose by 6.4% in the year to June. A further rise is expected following the government's decision to raise fuel prices that were frozen ahead of the general election. A cut in excise duties on petroleum products will soften the price impact.

**Long period of low interest rates may be coming to an end**

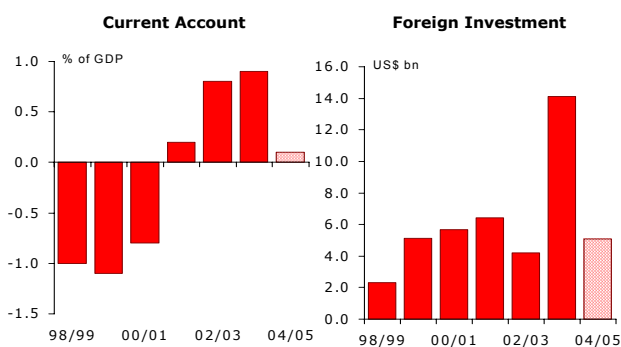


A period of low interest rates supported economic growth in 2003/04, with the RBI's benchmark bank rate held steady at 6% since May 2003. Bank rate is expected to remain steady in the short-term, but modest upward pressure on interest rates is likely to emerge if expectations that the recent rise in inflation is merely transient prove false, or if concerns about the accuracy of recent fiscal projections escalate.

## The current account surplus is likely to be eroded

Following a long run of annual current account deficits between 1980 and 2001, a small current account surplus equivalent to 0.2% of GDP was generated in 2001/02. The surplus rose to 0.8% of GDP in 2002/03 and is estimated to have remained close to that level in 2003/04. Oil accounts for approximately 26% of total imports and the current account surplus is likely to be eroded in 2004/05 unless there is a significant decline in the current level of international oil prices within the next few months.

### Less favourable balance of payments trends expected over the next two years



Source: Institute of International Finance

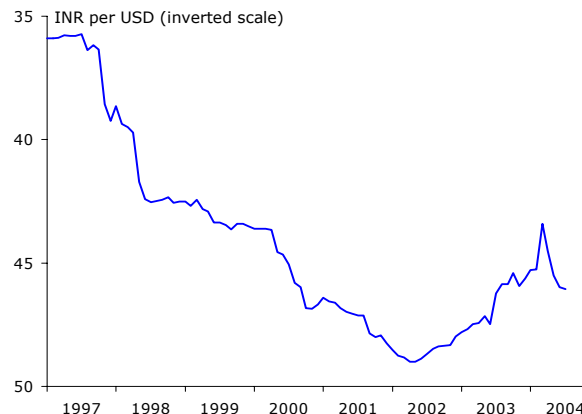
According to estimates prepared by the Institute of International Finance, total foreign investment rose from US\$4.2 bn in 2002/03 to approximately US\$14 bn in 2003/04. Total foreign investment is projected to decline to US\$5-6 bn over the next two years reflecting the much more cautious approach to privatisation and uncertainty about whether the new government will succeed in extending the economic reform process.

There has been a sharp rise in international reserves from US\$46 bn at end-2001 to US\$114 bn in April 2004 reflecting successive current account surpluses, the recent pronounced rise in foreign investment, and increased foreign borrowing, the attractions of which have been bolstered by the recent low level of international interest rates and the appreciation of the rupee against the US dollar since mid 2002. International reserves are currently sufficient for more than 12 months' imports.

There has also been an improvement in most external debt ratios over recent years. Total external debt as a proportion of exports declined from around 200% in March 2000 to an estimated 139% in March 2004. The debt service ratio,

which averaged 22.5% in 1998-2001, averaged 17% over the past 3 years.

### The rupee has lost some of its recent gains



Source: Datastream

The rupee rose against a weakening US dollar between May 2002 and March 2004. It has subsequently lost some of these gains, partly reflecting some modest general recovery in the US dollar, but also due to recent political surprises, uncertainties about future economic reform, and the detrimental impact of high oil prices.

The rupee seems within its fair-value zone and no significant move against the US dollar is expected over the next few months. While ANZ is forecasting a general depreciation of the US dollar over this period, the rupee is unlikely to be a major beneficiary due to the impact of more cautious foreign investor sentiment on capital inflows and the adverse impact of high oil prices.

### Economic reform is likely to be cautious in the short term

A reversal of the economic reform process is extremely unlikely, but only slow progress is likely over the next couple of years as the government will be severely constrained by the diverse composition of the new coalition and its reliance on the communist parties, opposed to many aspects of economic reform, for parliamentary support. The cautious attitude to privatisation will have an adverse impact on foreign investor confidence, but India's growing importance in an integrating global economy is unlikely to be derailed.

The new political leaders in India have strong credentials and are widely-admired. They need to show political courage in extending economic reform to all sections of society to boost economic growth and raise low living standards.

**Barry Coulthurst**  
[Economics@anz](mailto:Economics@anz)  
 Email: [coulthub@anz.com](mailto:coulthub@anz.com)

ANZ is represented in:

**AUSTRALIA by:**

Australia and New Zealand Banking Group Limited ABN 11 005 357 522  
10th Floor 100 Queen Street, Melbourne 3000, Australia  
Telephone +61 3 9273 6224 Fax +61 3 9273 5711

**UNITED KINGDOM by:**

Australia and New Zealand Banking Group Limited  
ABN 11 005 357 522  
Minerva House, PO Box 7, Montague Close, London, SE1 9DH, United Kingdom  
Telephone +44 20 7378 2121 Fax +44 20 7378 2378

**UNITED STATES OF AMERICA by:**

ANZ Securities, Inc. (Member of NASD and SIPC)  
6th Floor 1177 Avenue of the Americas  
New York, NY 10036, United States of America  
Tel: +1 212 801 9160 Fax: +1 212 801 9163

**NEW ZEALAND by:**

ANZ National Bank Limited  
Level 7, 1-9 Victoria Street, Wellington, New Zealand  
Telephone +64 4 802 2000

In Australia and the UK, ANZ Investment Bank is a business name of Australia and New Zealand Banking Group Limited, ABN 11 005 357 522 ("ANZ Bank"), which holds an Australian Financial Services licence no. 234527 and is authorised in the UK by the Financial Services Authority ("FSA"). In New Zealand, ANZ Investment Bank is a business name of ANZ National Bank Limited WN / 035976 ("ANZ NZ").

This document is being distributed in the United States by ANZ Securities, Inc. ("ANZ S") (an affiliated company of ANZ Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this document and wishing to effect transactions in any securities referred to herein should contact ANZ S, not its affiliates.

This document is being distributed in the United Kingdom by ANZ Bank for the information of its market counterparties and intermediate customers only. It is not intended for and must not be distributed to private customers. In the UK, ANZ Bank is regulated by the FSA. Nothing here excludes or restricts any duty or liability to a customer which ANZ Bank may have under the UK Financial Services and Markets Act 2000 or under the regulatory system as defined in the Rules of the FSA.

This document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any

recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZ Bank, ANZ NZ, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this document (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this document. If you have been referred to ANZ Bank, ANZ NZ, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this document accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. No part of the author's compensation was, is or will directly or indirectly relate to specific recommendations or views expressed about any securities or issuers in this document. ANZ Bank, ANZ NZ, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

Where the recipient of this publication conducts a business, the provisions of the Consumer Guarantees Act 1993 (NZ) shall not apply.

For further information, please email  
Economics@anz.com