

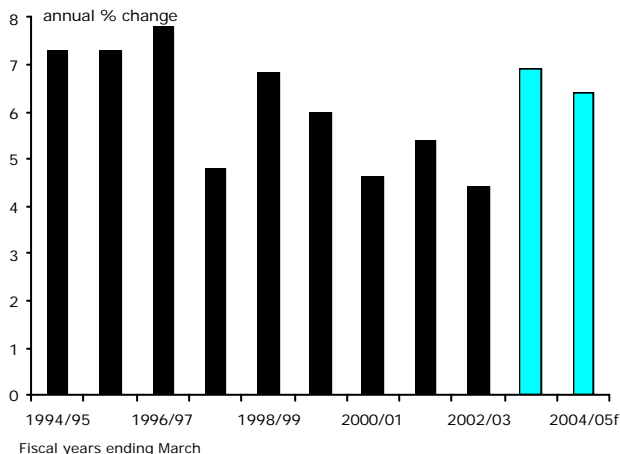
# Country Brief: India

Economic activity is recovering strongly, following last year's drought-induced slowdown, with real GDP growth forecast to reach around 7% in 2003/04. This would make India one of the fastest-growing economies in Asia while still lagging China. However, the forthcoming period of strong economic growth is likely to be short-lived unless the improved economic outlook is used to reduce the large fiscal deficit, and more vigorously pursue reforms to open the economy and remove constraints on the private sector. Alongside better economic news, hopes are mounting that India and Pakistan are serious in their latest attempt to improve relations.

## The BJP's good performance in state elections triggers speculation of an early election

The opposition Congress party retained power in only one of the four state elections contested in December 2003. The BJP, the main party in the ruling coalition, performed strongly which is encouraging hopes that the BJP-led coalition will retain power in the general election that is due by November 2004. The present BJP coalition government has completed over four years of its five-year term and the prospects of the BJP being re-elected are being assisted by the strong recovery in economic activity that is under way.

## Economic growth is now recovering strongly after being hit by severe drought in 2002/03



It is not yet clear whether the strong performance of the BJP in these recent state elections will lead Prime Minister Atal Behari Vajpayee to dissolve parliament and seek an early general election. Although the Prime Minister has ruled out a snap election, some senior BJP officials seem to favour an early poll, possibly next April. It is encouraging that the BJP did not adopt a hardline religious stance in the recent campaign, instead focussing on issues of development and governance. Some BJP politicians have interpreted the party's strong performance as support for further economic reform, but alternatively the loss of support suffered by Congress may have been due mainly to the usual swing against incumbent governments.

The electoral challenge posed by the main opposition Congress party is hampered by its internal divisions, doubts about the electoral strategy being pursued by its leader Sonia Gandhi, and growing uncertainty about whether the party is still committed to the economic liberalisation programme that was launched by a Congress government in 1991. The main threat to the BJP's re-election is from divisions within the party between Hindu hardliners and the moderate wing led by Prime Minister Vajpayee.

## India is trying to improve relations with Pakistan but Kashmir is a major problem

India is making renewed efforts to improve relations with Pakistan. In a speech in Kashmir in April 2003, Prime Minister Vajpayee offered a "hand of friendship" to Pakistan and this was followed in May by the restoration of full diplomatic relations and an offer to renew dialogue on issues that divide the two countries. This latest attempt to improve relations, which seems to be a personal initiative of Prime Minister Vajpayee, was followed by a series of practical ideas in October to strengthen "people-to-people" contacts, which include plans to improve transport links and renew sporting ties.

The reaction by Pakistan has been mixed. There was a positive response to the initiative in May, but the initial reaction to the October suggestions was unenthusiastic with claims that they represent little more than public relations. However, Pakistan subsequently became much more enthusiastic with its proposal in November for a ceasefire along the Line of Control that divides the disputed territory of Kashmir. The first formal ceasefire for 20 years took effect on 26 November, but India is concerned that it will quickly break down if there is any infiltration across the Line of Control. Agreement has also been reached on resuming direct air links from the start of 2004.

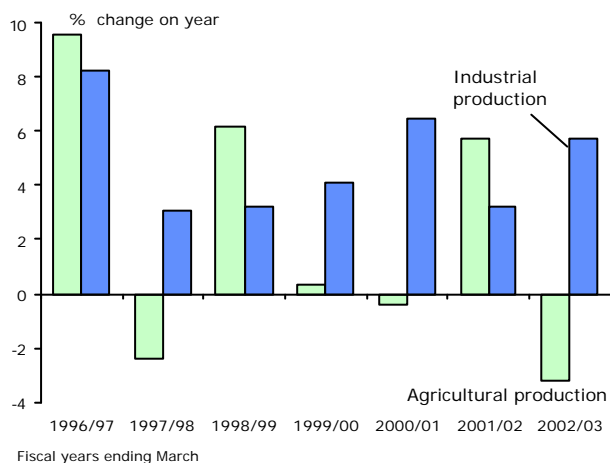
These moves represent significant progress in strengthening relations, but Kashmir remains a major problem that is unlikely to be solved quickly or easily. Pakistan is concerned about India's unwillingness to open talks specifically about Kashmir and its reluctance to commit to a new

summit between the leaders of the two countries. Pakistan's view is that an overall improvement in relations must follow political agreement on the future of the disputed province, rather than precede it. However, with both sides showing some flexibility and responding positively to the initiatives of the other, hopes are building of a further improvement in relations at a regional South Asia conference to be held in Islamabad in January 2004.

### The economy is recovering strongly

Real GDP growth recovered to 5.7% in the year to June 2003, a clear improvement from a low of 2.3% in December quarter 2002. The manufacturing sector grew by 6.4% in the year to June, while some services sectors grew by more than 7%.

#### Agricultural output fell by 3.2% in 2002/03



The economy had been adversely affected by a 3.2% decline in agricultural production in 2002/03, the biggest contraction since the present sectoral series began in 1981 and the result of the worst drought for 15 years. In contrast, industrial sector growth rose from 3.2% in 2001/02 to 5.7% in 2002/03, but this did not prevent a slowdown in real GDP growth from 5.4% in 2001/02 to 4.3% in 2002/03, the weakest result since the economic crisis in 1991.

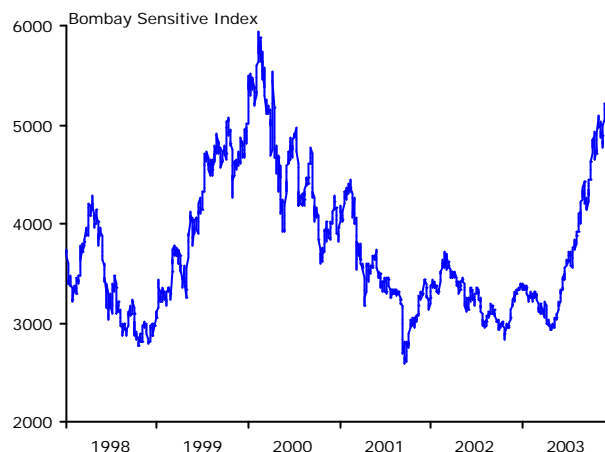
Agriculture accounts for approximately 23% of GDP with agricultural output a significant influence on the incomes of the rural work force which accounts for about 60% of the total. The beneficial impact of higher rural incomes on demand for motor bikes and other consumer goods operates with a lag of about 6 months so the main impact of the upturn in agriculture on industrial output is not expected until 2004. According to the monthly series, the growth of industrial production has fallen slightly

over recent months and during January-September was 6.0% above its year-earlier level.

With good monsoon rains providing the basis for recovery in agricultural output and boosting spending by the rural population, real GDP growth is expected to reach around 7% in 2003/04, which would represent the strongest increase since 1996/97.

The prospects of rapid economic recovery are also being bolstered by an improvement in business confidence and by strong increases in lending for housing and purchases of consumer durables. There are expectations that the favourable combination of stronger consumer demand and cheaper credit will boost corporate earnings and that this, in turn, will lead to increased private sector investment which will help to sustain the recovery.

#### The stock market has risen strongly



The stock market has risen strongly as economic prospects have improved, with the Bombay Sensitive Index rising by almost 55% between end-2002 and 9 December 2003.

A strong cyclical recovery in economic activity in the current fiscal year should make India one of the fastest growing economies in Asia while still lagging China. However, while economic prospects are the strongest for some years, overall economic performance continues to be constrained by the cautious pace of economic reform.

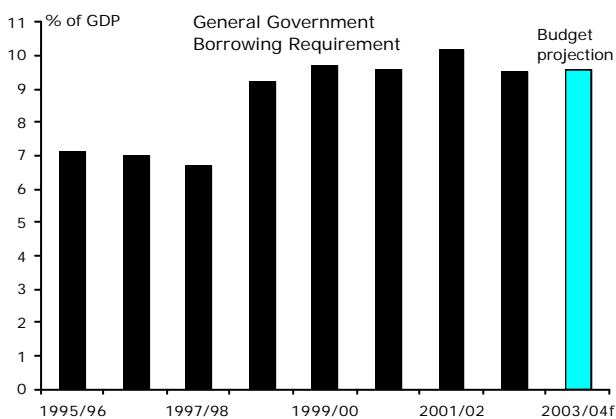
The forthcoming period of above-average economic growth is likely to be short-lived unless efforts to reduce the fiscal deficit and reforms to open the economy and remove constraints on the private sector are pursued more vigorously. Such reforms are essential to reduce constraints on government spending on infrastructure and boost private sector investment. Without faster reform, the

government will not achieve its annual growth target of 8% during 2002-07, and the latest flurry of predictions that India is at last poised to match China's economic growth rate will fail to be realised.

Following the recent state elections, the government has relaunched a campaign emphasising the benefits of economic reform in improving the living standards of ordinary Indians through better access to water, roads and electricity. This is a positive development that could help to reduce strong popular opposition to economic liberalisation, but the government remains unwilling to introduce fiscal reforms that would significantly reduce the budget deficit.

Several unambitious targets aimed at securing a modest reduction in the deficit have been missed over recent years. A small improvement, however, was secured in 2002/03 when the central government deficit declined to an estimated 6.0% of GDP from 6.3% in the previous year. There was also a modest improvement in the general government deficit, which includes state and local governments, from 10.2% of GDP to 9.5% over the same period.

**Efforts to reduce the fiscal deficit have been unsuccessful**



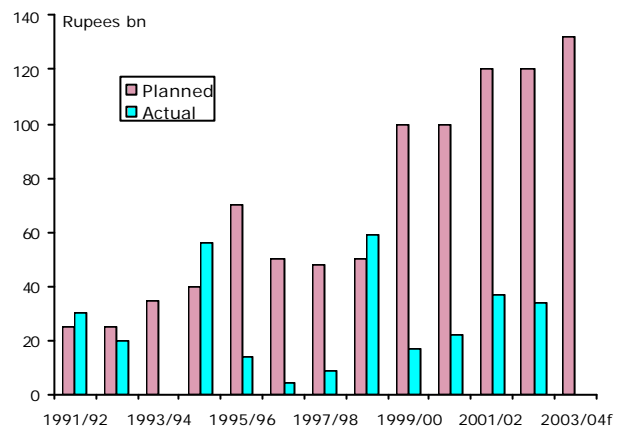
Source: Institute of International Finance

General government debt has reached about 80% of GDP and the World Bank is concerned that the high cost of servicing this debt is a serious constraint on public spending on infrastructure improvements. The high level of government debt is also a particular concern of the credit-rating agencies. It will continue to have a detrimental impact on India's credit ratings, and thus on the cost of international credit, but will not necessarily prevent an upgrade of some ratings provided recent signs of economic improvement in other areas are sustained. Concerns have been expressed that the government is being

complacent by not taking advantage of the recent improvement in the economic outlook to adopt a much more urgent approach to reducing the fiscal deficit.

According to the 2003/04 budget, there will be no reduction in the deficit this year with the government reluctant to introduce tough fiscal measures ahead of next year's general election. While this is disappointing, some specific measures in the 2003/04 budget were positive for economic prospects. Income tax surcharges were reduced and personal tax-free allowances raised. There were incentives to stimulate activity in several sectors and an ambitious road construction programme. The maximum import tariff was reduced from 30% to 25% although there are some agricultural exceptions. The improvement in the economic outlook since the budget was unveiled in February will have a beneficial impact on government revenue, but the extent to which this will be reflected in a lower fiscal deficit will depend on expenditure outcomes and the extent to which there is additional spending ahead of next year's general election.

**Privatisation proceeds keep falling short of the government's target**



Source: Indian Ministry of Finance

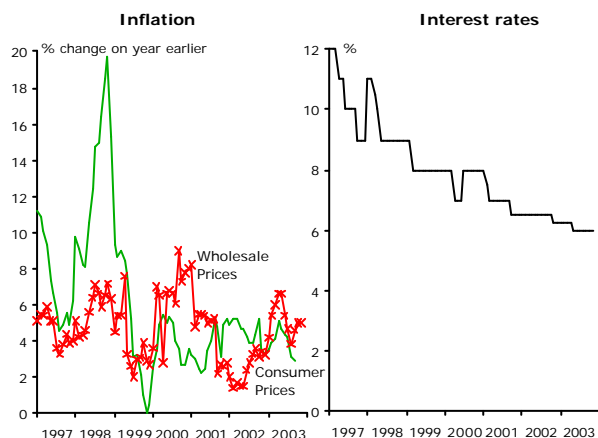
Privatisation proceeds have fallen well short of official targets over recent years. The target is INR132 bn in 2003/04, but this is also expected to be missed. In addition to the usual political and labour opposition, privatisation plans could be severely disrupted by the decision of the Supreme Court in September 2003 that plans to privatise two state oil companies require parliamentary approval, rather than going ahead at the government's discretion. The ruling applies to all state-owned entities that were nationalised by legislation so a number of other planned privatisations will also be affected. The government says that it is examining how this legal hurdle can be overcome, but it is reluctant to

actually seek parliamentary approval as this would expose deep divisions within the ruling 24-party coalition about privatisation and other economic reforms. In contrast, some analysts think that the court ruling could be beneficial to the overall economic reform process if it encouraged the government to set out the benefits of privatisation clearly and openly in parliament.

Parliament has already approved plans to privatise the country's largest airports, at New Delhi and Mumbai, which account for over half of total air traffic. A number of international airport operators are expected to bid for minority stakes in joint ventures with Indian businesses.

Inadequate infrastructure, including poor roads, congested ports, and inadequate supplies of electricity, is a serious constraint on the industrial sector although the overall impact on economic growth is partly offset by public spending to strengthen infrastructure. The government's ambitious road building programme is having a significant impact on demand for steel and cement. It is hoped that the approval of a new law in June 2003 that opens power generation, transmission and distribution to full competition will lead to significant investment in the power industry. There are, however, still some uncertainties about how the new legislation will be implemented and whether regulation of the power industry will be fully independent from political or bureaucratic interference. There are also some remaining obstacles such as the requirement for industrial users of electricity to subsidise some other users.

**Inflation is under control and interest rates have fallen**



A rise in inflation in early 2003 mainly reflected the adverse impact of higher oil prices. Inflation has subsequently moderated and the recovery in food production and recent appreciation of the rupee should help ensure that inflationary pressures are subdued in the foreseeable future.

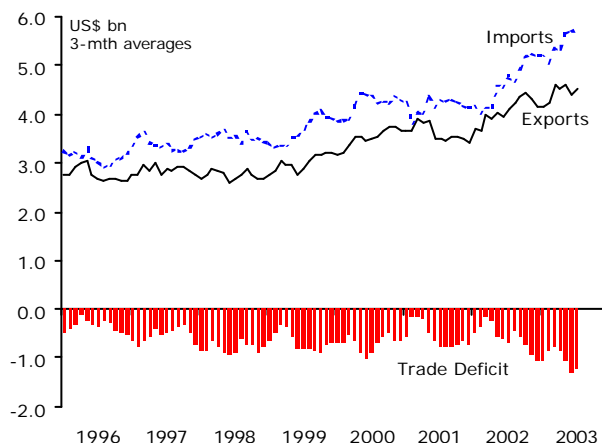
Monetary policy has been eased in a succession of cautious steps by the Reserve Bank involving reductions in official interest rates (the repo rate was cut by 50 bps in April and by another 50bps to 4.50% in August and the benchmark bank rate by 25 bps to 6.0% in May). The cash reserve requirement for commercial banks was lowered from 4.75% of eligible deposits to 4.50% in June. At its twice-yearly meeting in November, the Reserve Bank of India left its monetary stance unchanged when it held its bank rate steady at 6.0%. The RBI again warned about the large fiscal deficit and high level of public sector debt.

A number of reforms are being implemented to strengthen the banking sector, but risks remain high. Crisil, India's largest private credit rating agency, recently reported that almost 20% of banking sector loans are non-performing, twice as high as the RBI's estimate that NPLs accounted for 10% of total lending as at March 2003.

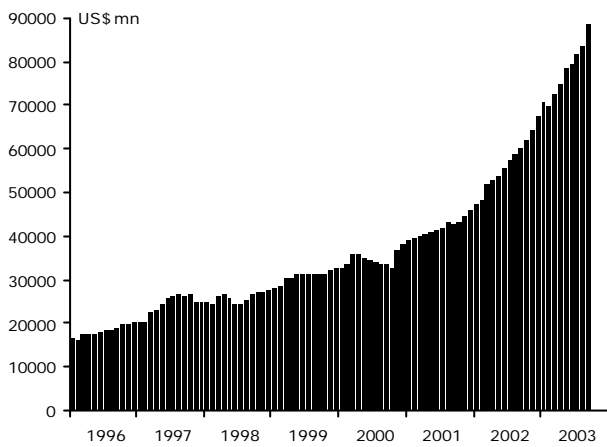
**Another small current account surplus is expected in 2003/04**

There has been a steady, albeit unspectacular, balance of payments improvement in recent years with the current account moving from a deficit equivalent to about 1% of GDP in 1999/00 to a surplus of 0.7% of GDP in 2002/03. The improvement is likely to be interrupted this year, reflecting the impact of economic recovery on demand for imports, lower import tariffs, the higher cost of imported oil that meets over 60% of total oil requirements, and the detrimental impact of an appreciating rupee on the growth of exports. The current account is expected to be close to balance in 2003/04, with most forecasters still envisaging a small surplus.

**The visible trade deficit is growing but ..**

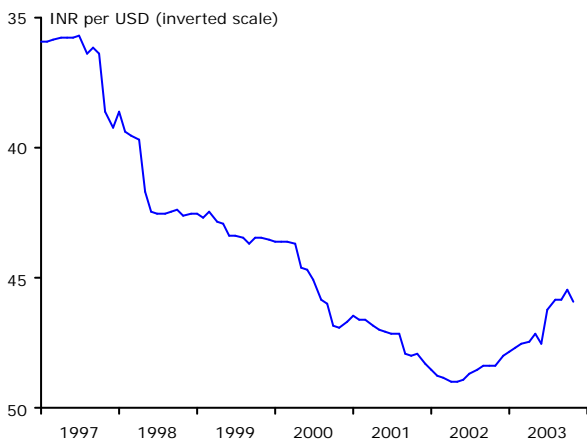


**.. international reserves are rising strongly**



The strong rise in international reserves over recent years has continued with reserves rising from US\$67.6 bn at end-2002 to US\$88.4 bn in September 2003, sufficient to provide import cover of more than 10 months.

**The rupee is appreciating against the US\$**



The rupee has risen against the weakening US dollar since May 2002, ending a long period of depreciation. The rupee rose by almost 8% between end-May 2002 and 10 December 2003 and is expected to continue to rise over coming months as the US dollar's decline continues.

The authorities are concerned that inflows of foreign funds could produce a strong rise in the rupee with a detrimental impact on export competitiveness, particularly in relation to countries with a fixed or tightly-controlled exchange rate against the US dollar. To reduce this risk, the authorities have taken several steps to limit the inflows of foreign funds. The government has recently rejected a number of applications by private companies to raise funds

overseas; the attractions of such borrowings are being bolstered by the prospect of further rupee appreciation against the US dollar at a time when US interest rates are well below domestic ones. As well as adding to current upward pressure on the rupee, the authorities are concerned that the bunching of repayments on foreign currency loans could create a potential source of strain in several years' time when balance of payments conditions may be less favourable than at present. In a move that reduces the favourable interest rate differential available to non-resident Indians, the Reserve Bank of India announced in October that it was lowering the ceiling on interest rates on expatriate deposit accounts.

**Further progress towards capital account convertibility**

These developments follow a series of recent moves to loosen restrictions on capital account. The amount of foreign exchange that residents can take abroad has been raised. The ceiling on mutual funds' holdings of foreign securities has been raised and individuals and companies are also being permitted to invest directly in certain foreign securities. Restrictions on the acquisition of foreign companies by Indian ones have been eased, while exporters are permitted to extend trade-related credits without restriction.

India has also responded to its strong external position by removing restrictions on the prepayment of external debt by private sector companies and announcing plans to pre-pay further chunks of official external debt in the current fiscal year. Debt ratios have improved steadily over the past few years with external debt declining from 26% of GDP in 1999 to 23% by March 2003 and, as a proportion of exports, from 218% to 146% over the same period. The debt service ratio has fallen from around 25% during 1997-2000 to 17.3% and 16.0% respectively in 2001/02 and 2002/03.

The volume of foreign investment remains modest, with annual net inflows averaging around US\$5 bn over the past few years. Although this total is disappointing, particularly when compared to substantial investment into China, the IT-related services sector with its highly-skilled labour force has achieved a leading position with many large international companies outsourcing their back office operations to India.

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

Australia and New Zealand Banking Group Limited is represented in:

**AUSTRALIA by:**

Australia and New Zealand Banking Group Limited ABN 11 005 357 522  
10<sup>th</sup> 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 +44 171 378 2121 Fax +44 171 378 2378

**UNITED STATES OF AMERICA by:**

ANZ Securities, Inc. (Member of NASD and SIPC)  
6<sup>th</sup> 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 Banking Group (New Zealand) Limited.  
Level 10 215-229 Lambton Quay Wellington, New Zealand  
Telephone +64 4 496 7000, Fax +64 4 496 7360

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 Banking Group (New Zealand) 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](mailto:Economics@anz.com)