BOFIT Online
2006 No. 3

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India's recent macroeconomic developments

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Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Online
Editor-in-Chief *Jouko Rautava*

BOFIT Online 3/2006

Aaron Mehrotra: India's recent macroeconomic developments
31.5.2006

ISSN 1456-811X (online)

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Abstract

We provide a brief overview of recent developments in the Indian macroeconomy, including aspects of the real economy, price developments, and monetary and fiscal policies. The picture that emerges is one of a rapidly growing economy, supported by strong domestic demand and credit flows. The economic boom has dragged the current account into deficit, while output growth has broadened to encompass the industrial sector. Fiscal deficit ratios have recently declined due to a rapid increase in the level of GDP, but public sector imbalances remain high, constraining necessary investments in health, education, physical infrastructure and overall poverty reduction.

Keywords: India, economic growth, monetary policy, fiscal policy

Thanks to Jouko Rautava for his helpful comments and discussions.

1 Introduction

In considering recent developments in the Indian macroeconomy, it is worth noting that while India's growth performance has often failed to meet expectations, the country has posted impressive growth in recent years. This is often overlooked as the service sector has occupied the limelight with worries about outsourcing and job losses in industrialised countries. In fact, India's economic growth is increasingly driven by the industrial sector. A strong domestic demand has been supported by significant credit from a reviving banking sector. Moreover, inflation remains under control, despite a demand-driven current account deficit and increased capital inflows that have boosted the central bank's foreign exchange reserves.

Fiscal imbalances remain a problem, even if the combined central and state government deficit ratio has declined since fiscal year 2002/03 (April to March) due to buoyant growth. With the current debt-to-GDP ratio at 85 per cent, little leeway exists for significant increases in much-needed public investment in infrastructure, health and education. The current levels of consumer and producer subsidies, many of them highly inefficient, further contribute to public sector imbalances. With public investment roughly constant throughout the current decade, much of the recent increase in India's investment ratio comes from private sector investment. The 2006/07 budget strives to address concerns about equitable growth in the Indian economy and ties in with recent plans for further liberalization of the capital account, the latter emphasizing the urgency of fiscal consolidation.

This paper is structured as follows. The following section discusses the recent growth experience, providing details about sectoral developments and India's external trade. Section 3 describes recent monetary policy, price developments and banking sector evolution. Section 4 considers aspects of exchange rate policy and capital flows. We end with a discussion of recent trends in fiscal policy and offer some conclusions.

2 Recent growth experience

Although the balance-of-payments crisis of 1991 led to considerable liberalisation of the Indian economy, economists note that the transition from "Hindu Growth" to a higher-growth era actually took place around 1980.[1] Nevertheless, the annual average growth in GDP per capita of 3.8 per cent during 1980-2000 looks anaemic compared to the 50 per cent increase (in PPP terms) over the current decade. The Government of India projects growth of 8.1 per cent for fiscal 2005/06, which follows growth rates of 8.5 per cent and 7.5 per cent during the past two years (see Table 1).

[1] For an overview of the debate on Indian growth transition and its causes, see Rodrik and Subramanian (2005) and Srinivasan (2005).

Table 1. Sectoral and total GDP, real growth rates at factor cost, % change over previous year

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Agriculture & allied	0.0	6.2	-6.9	10.0	0.7	2.3
Industry	6.3	2.7	7.0	7.6	8.6	9.0
Services	5.6	7.1	7.3	8.2	9.9	9.8
Total GDP	4.4	5.8	3.8	8.5	7.5	8.1

Source: Government of India
Note: Figures for 2004-2006 are estimates

Growth in the agricultural sector in 2005/06, supported by a normal monsoon, tripled relative to a weak 2004/05. Although agricultural production only accounts for a fifth of GDP, agriculture provides some 60 per cent of all employment. Agriculture remains highly dependent on weather conditions, but the government is hoping food processing will become a source of future growth and employment in rural areas.

Given the heated debate over outsourcing in industrialized countries and reporting on India's booming service sector, it has been easy to overlook the industrial sector growth rates of the past five years. Industrial output is expected to increase 9.0 per cent in 2005/06, slightly up from 8.6 per cent in 2004/05. Manufacturing and construction have led the way, supported by strong commercial bank credit flows. The service sector has also experienced broad-based growth, with estimates of annual growth at just below 10 per cent for both 2004/05 and 2005/06. Growth in "trade, hotels, transport and communication" reached double-digit figures for three years in a row, with the highest rate (12 per cent) recorded in 2003/04. Output in the financial services sector should increase about 9.5 per cent in 2005/06.

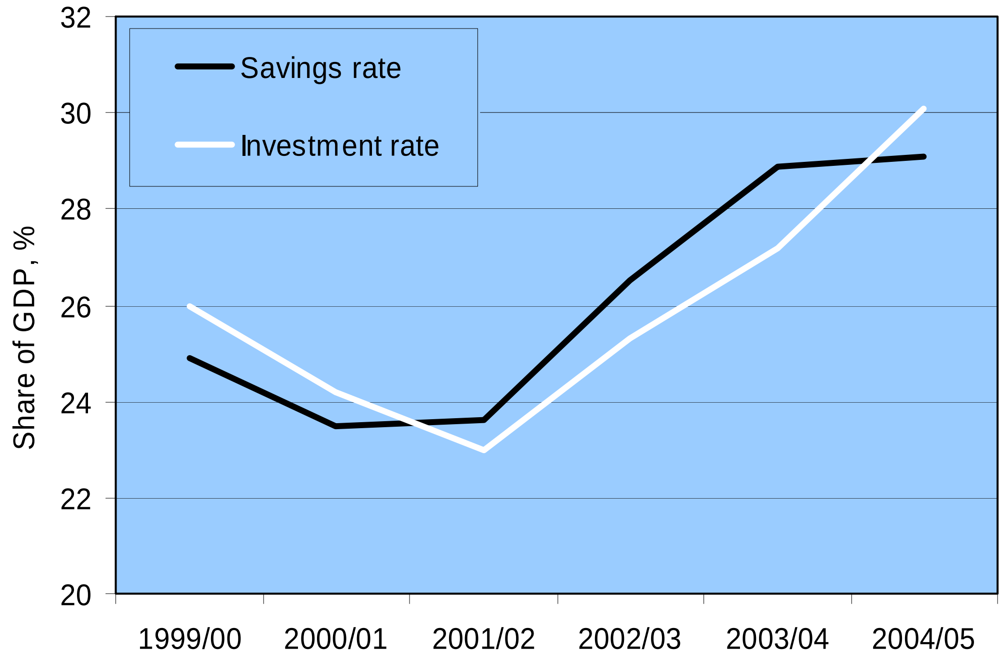
High growth at the aggregate level, however, masks important differences between states in terms of their growth experience. As an example, the per capita GDP of the state of Gujarat was over four times that of Bihar in 2003/04. This difference partly formed the basis for the disillusionment with the failure of the Bharatiya Janata Party (BJP) to extend the benefits of rapid economic growth ("shining" India) to rural residents and helped fuel the rise to power of the Congress Party in 2004. The Congress Party, however, needs support from the other parties in its United Progressive Alliance (UPA) coalition to maintain a parliamentary majority. Thus, public attention has focused on the ability of the Congress Party and Prime Minister Manmohan Singh to push through reforms without being blocked by the Left Front, in which the Communist Party of India (Marxist) holds prominent status. It appears that achieving a single set of national objectives and uniform growth will remain a challenge.[2]

The ratio of gross domestic investment to GDP ratio has fluctuated during 2001-2005, but overall has increased by a total of 7 percentage points to 30 per cent (see Figure 1). This is due mostly to an increase in private sector capital formation; public investment to GDP has remained relatively stable during this decade. The share of fixed investments to GDP has been on a modestly rising trend in recent years, growing by two percentage points to just below 25 per cent in 2005. The increase in the investment ratio has been accompanied by an increase in the national savings ratio from below 24 per cent in

[2] See e.g. Rangnekar and Sharma (2006), The Economist (2005).

2000/01 to 29 per cent in 2004/05. The increase in capital formation by less than savings is reflected in a current account surplus in 2001-2004. The recent boom in domestic demand has brought about a negative saving-investment gap and dragged the current account into a deficit in 2004/05.

Figure 1. Savings and investment (domestic), % of current GDP at market prices, 1999-2005



Source: Government of India

In the external sector, booming domestic demand and oil price hikes led to increased imports and a consequent current account deficit in 2004/05 for the first time in three years. Similarly, the trade balance posted a deficit of over 5 per cent of GDP in 2004/05, as shown in Table 2 below. Despite negative trade balances throughout this decade, the current account recorded surpluses in 2001-2004 due to a positive invisibles balance. Traditionally, India's positive invisibles have been dominated by workers' remittances from abroad. The World Bank reports remittances to India amounted to almost USD 22 billion in 2004 – the highest such foreign exchange inflow in the world.

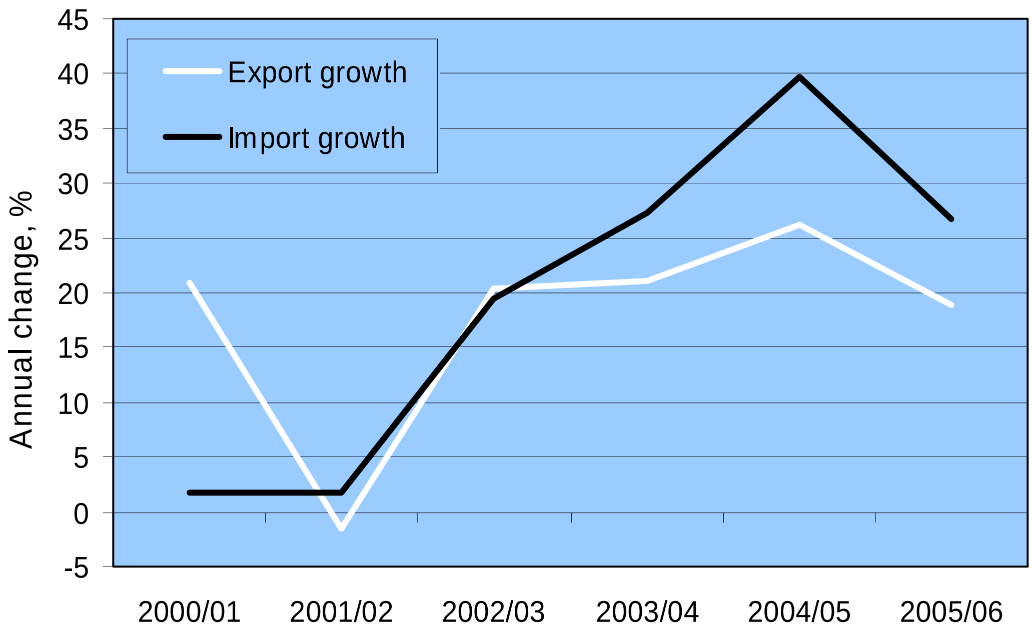
Table 2. Trade balance and current account balance, % of GDP

	2000/01	2001/02	2002/03	2003/04	2004/05
Trade balance	-2.7	-2.4	-2.1	-2.3	-5.3
Current account balance	-0.6	0.7	1.3	2.3	-0.8

Source: Government of India

Figure 2 displays the annual growth rate in exports and imports (USD value) during the current decade. Export growth has been strong since 2003/04, despite signs of a slowdown during 2005/06. Indian merchandise exports increased 18 per cent in April-December 2005, down from nearly 27 per cent in the same period a year earlier. The slowdown in merchandise export growth was experienced in the categories of engineering goods, textiles and clothing, and gems and jewellery. Perhaps because these product classes represent important components of India's merchandise export structure, the Reserve Bank has argued for the urgency of developing a supportive policy environment to increase export competitiveness,[3] through e.g. development of infrastructure and simplification of export procedures. Despite lower growth rates for merchandise export growth, services exports have remained strong. In 2004/05 services export growth hit 71 per cent, with software service exports expanding by 34 per cent. A notable phenomenon has been the growth in business services, up 216 per cent in 2004/05, and which has recently eclipsed the value of software services exports.

Figure 2. Export and import growth, annual percentage changes (USD value)



Source: Government of India
Note. 2005/06 figure covers period April-January.

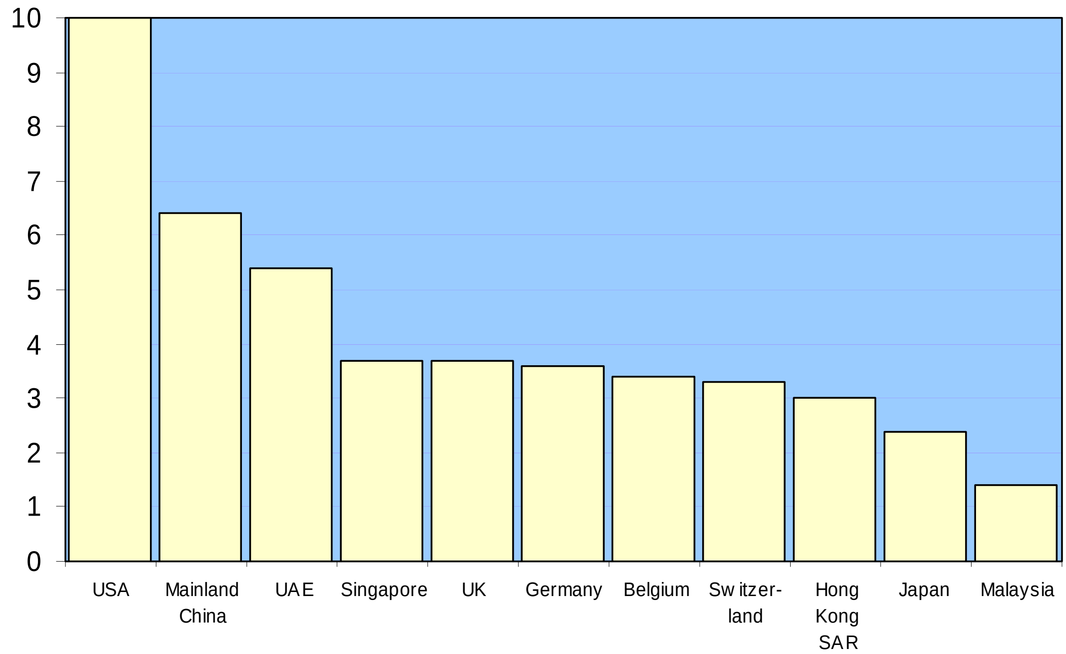
International Financial Statistics data suggest that the share of India in world exports has increased only by a tenth of a percentage point to a mere 0.8 per cent from 2001 to 2005 (January-August).[4] China's share climbed from 4.3 to 7.2 per cent in the period. Although the US retains its standing as India's main trading partner, China has rapidly gained prominence. In Figure 3 below, we illustrate the percentage shares of India's most

[3] RBI (2006c)

[4] Government of India (2006a)

important trading partners, as shares of total trade, in 2005 (April-October). The share of Mainland China has increased from 2.5 per cent in 2000/01 to 6.4 per cent in 2005, surpassing the United Arab Emirates for second place. When the trade with Hong Kong SAR is added to the figure for Mainland China, their combined share is strikingly close to that of the US (9.4 per cent vs. 10.0 per cent).

Figure 3. India's 11 major trading partners and their percentage shares in India's total trade, April-October 2005



Source: Government of India.

3 Monetary policy, prices and the banking sector

The Preamble of the Reserve Bank of India states that the objective of the Mumbai-based central bank is to "regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

Although the preamble does not explicitly mention price stability, the central bank's two objectives as a monetary authority are price stability and provision of an adequate flow of credit to productive sectors of the Indian economy. Both objectives have been quite satisfactorily achieved in recent years. Regarding price stability (Table 3), headline inflation measured in terms of wholesale prices (WPI, annual inflation) has been relatively stable at around the 5 per cent level. The WPI inflation rate of 4.5 per cent in January 2006 represents a decline of almost a percentage point from a year earlier. The consumer price index for industrial workers (CPI-IW) is perhaps a better cost-of-living measure than the WPI. It is measured on the basis of retail prices, with food products given a higher weight. Inflation measured by the CPI-IW, although increasing, remained below WPI inflation during 2002-2005. Price pressures have recently stemmed from higher oil prices and increasing asset prices – and possibly supply-side constraints resulting from buoyant growth. The Reserve Bank sees the inflation outcome for 2005/06 driven by price movements in commodities such as vegetables, iron, steel and petroleum products.[5]

Table 3. Year-on-year WPI inflation and CPI inflation for industrial workers, %

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
WPI, all commodities	5.5	1.6	6.5	4.6	5.1	4.5
CPI-IW	2.5	5.2	4.1	3.5	4.2	5.3

Source: Government of India
Note: Figures ending in March, except for 2005/06 period, which refers to WPI inflation for January 2006 and CPI for November 2005.

The pass-through from crude oil prices to prices of domestic petroleum products has been limited to gasoline and diesel fuel, with the prices of liquefied petroleum gas and kerosene oil unchanged during 2005/06. Price controls create quasi-fiscal costs estimated to amount to 0.7 per cent of GDP in 2004/05 and 0.5 per cent of annual GDP in the first half of fiscal year 2005/06. With unchanged petroleum prices and oil prices remaining at USD 60/bbl, these subsidies may have exceeded 1 per cent of GDP in fiscal 2005/06.[6] Explicit budget subsidies only amount to 0.1 per cent of GDP per year, with the remainder of the costs being borne by the state petroleum companies. These subsidies encourage inefficient consumption of energy and often benefit those least in need of the subsidy. The IMF notes that elimination of subsidies would substantially worsen the level of real consumption for poor households, and suggests cash transfers could be used to protect the most vulnerable. The incomplete pass-through of oil prices and the fiscal need to alter the subsidy system clearly suggest increasing inflationary pressures on the economy.

In terms of the Reserve Bank's second objective of credit provision, India's rates of credit growth have recently been among the highest in Asia, with bank credit growing by over 30 per cent in 2004/05. Credit flows have been significant to the housing and retail sectors.[7] However, the increase in credit to industry has also been notable, in line with fast growth in this sector. Credit growth in medium and large industries in 2004/05 amounted to over 17 per cent, while the growth rate was only 5 per cent in the previous year. A further acceleration has been experienced in 2005/06, with the year-on-year credit growth in the industrial sector at just below 46 per cent as of end-October, 2005. As credit growth has also picked up in the priority sectors (including small-scale industry and agriculture), the increase in lending has been broad-based in terms of its destination. However, the credit-to-GDP ratio in India still remains at just 40 per cent.

Recent increases in the policy interest rate for the RBI (reverse repo rate) have clearly been associated with the aim of curbing inflation and inflationary expectations. Policy rates were hiked in 25-basis-point increments in October 2004, April 2005, October

[5] RBI (2006a)
[6] IMF (2006b)
[7] IMF (2006a), Government of India (2006a)

2005 and January 2006. The reverse repo rate presently stands at 5.5 per cent. These contractionary measures have been combined with increased reserve requirements by the Reserve Bank. However, given a rate of WPI of 4.5 per cent in January 2006, real interest rates remain low, partly contributing to the strong credit growth in the Indian economy.

In 2003/04, total bank assets in India added up to slightly over 70 per cent of GDP. The Indian banking system has a large number of banks with mixed ownership.[8] Although there are both commercial and cooperative banks, commercial banking accounts for 98 per cent of banking system assets. In addition to public sector banks, it includes 40 private sector banks and 33 foreign banks. The state holds majority ownership in 27 public sector banks in the commercial banking segment. State-controlled banks continue to dominate the Indian banking sector. They held 74 per cent of assets in the domestic banking sector in 2005, which represents a moderate decline from the share of 90 per cent owned by the public sector still in 1991. Nine of the ten largest banks are state controlled, and the share of government securities in the banks' asset structure is still substantial. The modest size of Indian banks is reflected in the fact that only one Indian bank, the State Bank of India, falls within the 250 largest global banks in terms of assets.[9]

Foreign banks gained permission to establish wholly-owned subsidiaries in 2005 (previously only branches were permitted), but foreign direct investment is still limited to banks identified by the Reserve Bank to be in need of restructuring. In this way, a foreign bank can acquire controlling stake "in a phased manner."[10] Foreign banks presently account for 7 per cent of total banking system assets and hold 5 per cent of deposits. They can engage in any financial sector activity, but the share of foreign banks in the Indian banking system remains quite low.

In early 2005, detailed prudential guidelines were issued to banks in view of implementing the new capital adequacy framework as defined by the Basel II standards. Banks must adopt the standardized approaches for operational and credit risk by end of 2006/07. Such a rapid schedule requires further development of risk management skills in banks and at the supervisory level. However, according to data from the Reserve Bank, the health of the commercial banking system has improved in the recent years. The ratio of gross nonperforming loans (NPLs) in commercial banks fell from close to 16 per cent at end-March 1997 to 7 per cent at end-March 2004. Notably, improvements have been recorded in both public sector and private sector banks (in the latter, the NPL ratios have declined for both domestic and foreign banks). A similar development can be seen in Table 4, where the percentage of non-performing assets of scheduled commercial banks to total assets is shown. These ratios have declined for both public and private sector banks.

[8] Data on banking sector structure mainly from Prasad and Ghosh (2005)

[9] Fitch (2005)

[10] RBI (2005), IMF (2006a)

Table 4. Non-performing assets of scheduled commercial banks, percentage of total assets

	2002/03	2003/04	2004/05
Public sector	4.2	3.5	2.8
Private sector	4.0	2.8	2.1
Foreign banks	2.4	2.1	1.4
All groups	4.0	3.3	2.6

Source: Government of India

The amount of non-performing loans held by all financial institutions in India, at USD 30 billion in 2003, accounted for 2.3 per cent of non-performing loans globally that year. This contrasts with a global share of 23.6 per cent held by Chinese financial institutions.[11]

4 Exchange rate policy and capital flows

Despite periodic interventions by the Reserve Bank, the Indian rupee has essentially been permitted to float against other currencies since March 1993. No fixed target or fluctuation band has been in place during this period, although the exchange rate has been subject to relatively close monitoring and management. Possibly due to reduced intervention by the Reserve Bank, there have recently been increased fluctuations in the rupee/dollar exchange rate. A depreciation of the rupee by over 6 per cent between August 2005 and December 2005 was followed with an appreciation of almost 4 per cent, taking the rupee/dollar rate to 44.6 (or 53.7 rupees against the euro) at end-March 2006 (see Figure 4). The Indian currency briefly touched its weakest point during this decade at 49 rupees against the dollar in mid-2002. The real effective exchange rate has risen recently, but estimates of misalignment of the actual rate with respect to equilibrium exchange rates (admittedly a difficult concept in the context of developing economies) mostly point to continued undervaluation of the rupee.[12]

The rupee is still only convertible on the current account. It has been suggested that capital controls have largely worked to India's benefit (e.g. the Indian economy coped well with the Asian financial crisis in the late 1990s). An important step to capital account liberalization came in March 2006, when the finance ministry and central bank were asked by the government to draw up a roadmap for greater capital account convertibility. The Committee set by the Reserve Bank is expected to submit its report before the end of July 2006.[13] Facilitating access to capital, the abolition of capital controls may contribute to higher growth in the Indian economy, but it may also help increase the prominence of Mumbai as a regional financial centre. However, the need for fiscal consolidation becomes

[11] Ernst & Young (2004)
[12] IMF (2006b)
[13] RBI (2006b)

even more urgent with capital account liberalisation, and in this regard, capital account reform could be used by the government to promote further fiscal tightening.

Figure 4. Rupee/USD exchange rate, July 2005-April 2006

Source: Reserve Bank of India.

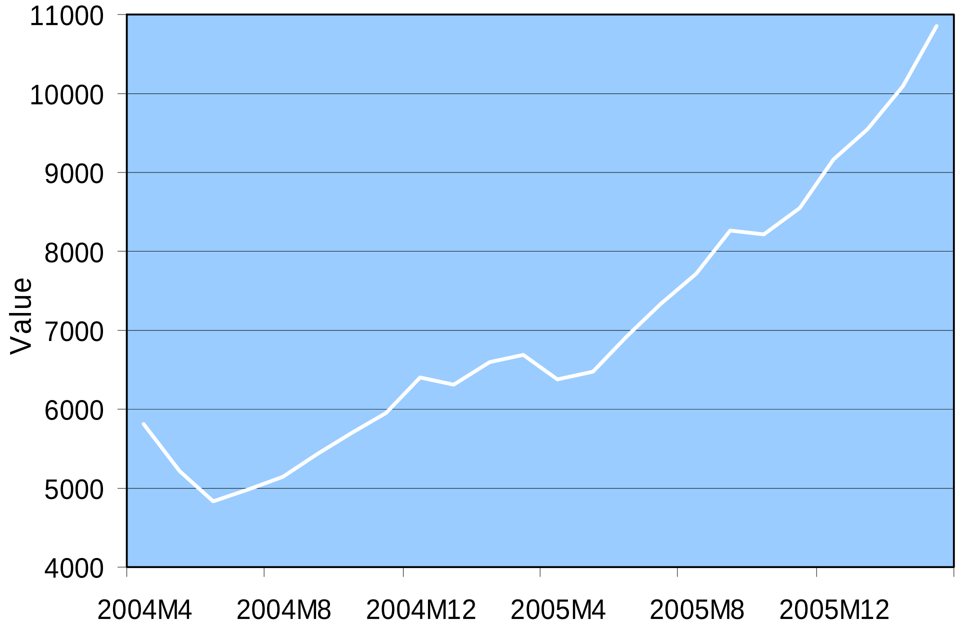
Despite political opposition to reform, the moment seems opportune to take steps towards capital account liberalisation. Capital flows to the Indian economy have surged in recent years. Portfolio investment has increased in importance and now accounts for a third of total private capital inflows. Private capital flows to the equity market have been important as legislative barriers limit the possibility for foreign investors to invest in debt markets.[14] Empirical research suggests that foreign institutional investment (FII) flows to and from the Indian market are caused by the return in the domestic equity market rather than the other way around.[15] Recent growth in the real economy and the Indian equity market then makes the expansion in portfolio inflows easily explainable, and these inflows further contribute to the buoyant development in share prices. The Sensex Index recorded a gain of over 40 per cent in USD terms in 2005 (see Figure 5 for recent development of the index). Economists have noted that while portfolio equity flows to India have been small compared to other emerging markets during 1993-2001, they have been less volatile and quite resilient.[16] This perhaps reflects a low level of integration with the world economy that provides India with partial insulation against external shocks.

[14] IMF (2006a)

[15] Mukherjee, Bose and Coondoo (2002)

[16] Gordon and Gupta (2003)

Figure 5. BSE Sensex Index, monthly average of end-day values, April 2004-March 2006



Source: Reserve Bank of India.

The principle instrument for managing capital inflows in India has been sterilisation. To neutralise the impact of rising net foreign exchange assets in the monetary base, the Reserve Bank has sold government securities from its portfolio. Of course, inflows may render domestic monetary policy ineffective when the tightening in domestic policy is completely offset by an expansion of net foreign exchange assets. Econometric tests suggest, however, that the capital inflows were not induced by domestic monetary conditions.[17] Sterilised intervention has apparently not resulted in an increase in interest rates in India, as evidenced by the decline in the average cost of government borrowing in recent years.

The inability of the Indian economy to attract large amounts of foreign direct investment (FDI), another important component of capital flows, has been the topic of considerable public discussion. Even accepting that we can nearly double the amount of FDI inflows to India by applying the IMF's standard definition for FDI and can discount a third of China's FDI as "round-tripping" domestic capital merely leaving and re-entering the country,[18] a quick calculation suggests that there is still a gap of USD 30 billion between the amount of FDI attracted by China and India. Net FDI flows in India are further reduced by the fact that Indian firms are increasingly eager to invest abroad. There are also differences in implementing reform measures related to FDI at the state level. Reform tasks in general are likely to remain difficult for the Congress Party, with the Left further strengthening its position in recent state polls (notably in West Bengal and Kerala) in April-May 2006.

[17] See Mohan (2005) for evidence from causality tests

[18] See Restall (2006)

India's foreign exchange reserves have risen rapidly, standing at USD 140 billion in January 2006. Even so, this is but a sixth of China's ballooning reserves. The growth in Indian foreign currency reserves by USD 92 billion during 2002-2005 contributed by 5 per cent to the total world reserve growth during the same time period. This contrasts with a share of 29 per cent for China and 24 per cent for Japan.[19] The reserves provide self-insurance against future financial crises (the tendency for reserve accumulation has been widely observed in Asia since the financial crisis of 1997-1998). India's large reserves exceeded the stock of foreign portfolio investment, short-term foreign debt and deposits by non-resident Indians by USD 50 billion, which reduces the risk from rapid reversals of capital flows. Additionally, the import cover of the foreign exchange reserves amounted to over 11 months in April-September 2005. Despite the recent pickup in import growth, this is still significantly above the 2.5-month figure recorded for 1990/91.[20]

5 Some fiscal policy observations

India's federal structure, 28 states and seven union territories, justifies a brief look at the fiscal balances at both the state and central government levels. Indian fiscal policy has increasingly focused on improving the country's infrastructure, including investment in health and education, while attempting to pursue fiscal consolidation. Indian authorities acknowledge that high deficits, unproductive expenditure and tax distortions prevented the economy from attaining its growth potential in the past.[21]

The Fiscal Responsibility and Management Act of 2003 emphasized revenue-based fiscal consolidation, the removal of distortions from the tax system and the attainment of better expenditure outcomes. Imbalances at the state level, in particular, necessitated the introduction of a restructuring scheme. The Twelfth Finance Commission (TFC), appointed in November 2002, contributed to this aim.[22] The terms of reference of the TFC included reviewing the state of the finances of the federal government and the states, and suggesting a fiscal consolidation plan whereby macroeconomic stability, debt reduction and equitable growth would be achieved.[23] Importantly, the TFC recommended that every state must eliminate its revenue deficit entirely by 2008/09.[24] At the state level, the gross fiscal deficit exceeded 4 per cent until 2004/05, after which a consolidation has taken place (see Table 5 below). The gross deficit at the state level is expected to amount to about 3 per cent of GDP in 2005/06.

Debt relief for the states would only be provided if fiscal responsibility legislation to achieve the necessary consolidation is implemented. The TFC also suggested the abolition of the present arrangement of providing federal assistance for state plans, which is currently comprised of both grant and loan components. In the future, each state must decide its own borrowing and implement it through the market. The centre would generally

[19] ECB (2006)

[20] IMF (2006a), Government of India (2006a)

[21] Government of India (2006a)

[22] India's Finance Commission, a constitutional authority in the area of public finance, is appointed every five years. Its task is mediating resource-sharing between the central and state governments.

[23] Government of India (2005)

[24] The revenue deficit refers roughly to the fiscal deficit less the government's capital expenditure (e.g. on infrastructure projects, see Moorthy, 2005).

be confined to extending pure grants to the states. In the case of fiscally weak states unable to raise funds in the market, however, the central government could act as an intermediary for lending.

In terms of consolidated general government balances, the gross fiscal deficit (including both central and state governments) has declined in the current decade but remains at high levels (see Table 5). The gross fiscal deficit peaked at 9.9 per cent of GDP in 2001/02 then declined to an estimated 7.7 per cent of GDP in 2005/06. Deficit has remained high, as tax receipts as a ratio to GDP have stood at a level of roughly 15 per cent to GDP, with total expenditures at approximately 30 per cent of GDP. General government debt has remained at roughly 85 per cent of GDP since the fiscal year 2002/03. Some consolation is provided by the fact that the debt is mostly domestically held, and denominated in rupees.

Table 5. Fiscal deficit, levels of government, % of GDP

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
State	4.3	4.2	4.2	4.4	3.8	3.1
Central	5.7	6.2	5.9	4.5	4.5	4.1
General	9.5	9.9	9.6	8.5	8.4	7.7

Source: Government of India
Note: Figures for 2005/06 are budget estimates (state & general), figures for 2004/05 are revised estimates.

Fiscal policy lately has stressed the provision of social services and rural development. Among recent measures to provide equitable growth to rural areas, the national rural employment guarantee bill received heavy publicity. This bill seeks to provide initially an employment guarantee in 150 of the most backward areas in India, and then extend that protection to the entire country within a five-year period. The employment guarantee covers at least one member in each rural household for 100 days per year. The bill has received criticism on the basis of being unproductive and because the amount of money allocated for rural families may be inadequate. Critics also claim the fiscal costs of the scheme could be huge. At the time of passing the bill, the government claimed an unemployment benefit would be granted where guaranteed wage employment was not provided. In any case, the bill provides a social security net which could have a strong positive impact on poverty reduction and consumption spending. The projects also improve rural infrastructure.

The budget for fiscal 2006/07 was presented by Finance Minister Chidambaram in late February. It addresses poverty concerns and includes higher spending on health (up 22 per cent) and education (up almost 32 per cent), while allowing for simultaneous fiscal consolidation thanks to rapid economic growth. The urgency of further spending on health and education is reflected by India's relatively poor performance in terms of the Human Development Index (HDI) of the United Nations. While India's ranking has remained unchanged at 127 for three years in a row (as reported in Human Development Reports 2003-2005), China climbed in the rankings from 104 to 85. Further infrastructure spending is planned, including completion of a major part of a highway project to connect the four corners of India to its capital. The central government's deficit numbers for the fiscal year 2005/06 were revised downwards to 4.1 per cent, and further consolidation is sought for 2006/07 with a central government budget estimate of 3.8 per cent. The revenue deficit is similarly estimated to fall by half a percentage point to 2.1 per cent in 2006/07. The budget also provides significant transfers to the states as recommended by the Twelfth Finance Commission.

The issue of subsidies remains intractable, however. The Asian Development Bank points out that no attempts were made in the previous (2005/06) budget to reduce subsidies or deal with India's infamously rigid labour laws.[25] Subsidies are estimated to amount currently to about 14 per cent of GDP. Regarding labour laws, the extreme difficulty of firms with more than 100 workers in making redundancies has deterred employers from hiring new employees and taking advantage of economies of scale. This could also explain why India has managed to thrive in capital, rather than labour-intensive, sectors (the latter including manufacturing). The small-scale industries reservation policy that requires that some labour-intensive production be handled by small firms, has probably added to this effect, although the regulations have been relaxed recently.[26]

In terms of direct taxes, the 2006/07 budget for does not change the rates of personal or corporate income taxes and does not impose any new taxes. Given the booming economy, one could easily argue in favour of further consolidation by increasing tax revenues, especially as increases in social spending are high in the government's agenda. Such measures, if they increase private sector consumption through falling risk premia and higher credibility, could prove to be expansionary (non-Keynesian effects of fiscal policy). In this regard, some of the literature on fiscal policy detects larger expansionary effects for fiscal consolidations resulting from changes in taxation than from changes in spending.[27] As consolidation partly comes about through higher GDP growth, there is also the question of whether India has permanently moved to a higher growth path. If so, economic expansion could be relied on to lower the deficit and debt ratios. Due to the need to address poverty issues and similar social concerns, the case for spending-based consolidation may be weak. Similarly, non-Keynesian effects (in terms of higher GDP growth) of fiscal policy through this route are probably more difficult to attain. However, scope for productivity increases in the sphere of public expenditure remains, especially when it comes to the extremely high level of consumer and producer subsidies.[28]

[25] ADB (2005)

[26] See Panagariya (2005), The Economist (2005)

[27] Giavazzi, Jappelli and Pagano (2000)

[28] Government of India (2006a)

6 Conclusions

The Indian government has recently signalled its intention to lift the economy to a higher growth path, whereby GDP would expand at an annual rate of 10 per cent. High growth, according to the government, provides the best antidote to poverty.[29] The economic expansion that started in 2003/04 provides evidence that India's growth rates in favourable circumstances are comparable to Asia's powerhouse, China (although the growth experiences of the two countries differ in many respects). Whereas high domestic demand has increased inflationary pressures in the Indian economy and dragged the current account into deficit, China's economy has experienced deflationary tendencies that seem to reflect excess supply in the economy. In this regard, investment in infrastructure is imperative to increase the supply-side potential of the Indian economy. It is equally critical to push forward with the economic reforms that have progressed slowly of late, especially in terms of privatization and labour laws. The recent growth in industry is a positive sign of the economic expansion reaching beyond the services sector – a necessary evolution for employment growth and further progress in poverty reduction. An increase in fiscal revenues would provide resources for spending in education, health and infrastructure, without further worsening the delicate state of fiscal balances. A gradual phasing-out of budget subsidies, replaced by direct cash transfers, could also form an important part of fiscal reform.

[29] Chidambaram (2006)

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