RATING PERSPECTIVE

Republic of India: The Indian economy grows fast – Its challenge and prospect

The Indian economy has been rapidly enhancing its presence as one of the leading powers in the world IT market. In recent years, it has drawn global attention as one of the BRICs as more foreign automakers and steel producers step up their investment there against the backdrop of a fast growing private consumption led by the middle-class people. It is highly likely that the Indian economy in FY2006 (from April 2006 to March 2007) posted a real GDP growth rate that matches the previous year's 8.8%. In a shorter term, its expansion may somewhat slow down due to the impact of the monetary tightening that has been in force to stem the inflationary trends caused by an economic overheating. In the medium to long terms, however, an annual economic growth rate higher than 7% will be within reach.

In stark contrast with the steady economic growth, the country's political situation looks less favorable. The Congress which leads the current coalition government, the United Progressive Alliance (UPA), has suffered setbacks in two successive state congressional elections early this year. Faced with a severer political situation, the government of Prime Minister Manmohan Singh may have greater difficulties in steering its policies. However, the coalition government is expected to stay in power until the next general election scheduled for April 2009. It is less likely for the country's political stability to be severely damaged.

This report reviews some of the challenges the Indian economy faces in maintaining the current high growth under the coalition government and its prospect in the future.

1. Economic situation

1.1 Short-term outlook

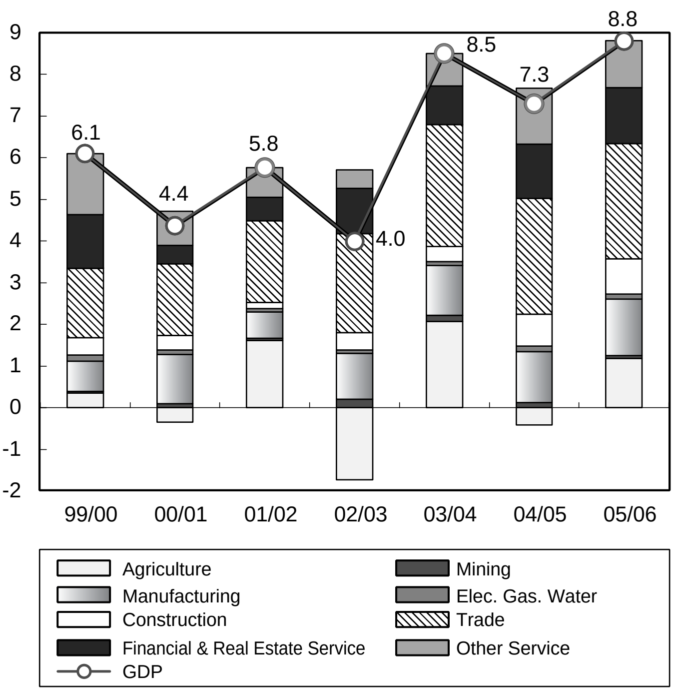
The Indian economy displayed its growing presence to the world as one of the BRICs by achieving a high 8.8% GDP growth rate in FY2005, which matched that of the Chinese economy. Much of the growth came from the agricultural sector, which recovered to a 5.8% expansion from a 1.9% contraction the previous fiscal year, as well as the service sector which continued its robust growth and the manufacturing sector which was supported by a strong export growth (Graph 1). The Indian economy grew a real 8.6% in the first three quarters of FY2006 (April-December 2006), as a moderate deceleration of the agricultural sector was more than offset by a further acceleration of the manufacturing and service sectors centering on commerce. The economic growth rate might have slightly decelerated in the fourth quarter as the production of both manufactured goods and consumer durable goods had been on the downtrend as illustrated by the latest industrial production indicators. However, a real GDP growth rate somewhere between 8.5% and 9.0% was believed to have been achieved in FY2006 as a whole (Graphs 2 and 3).

Meanwhile, as the Indian economy continued growing 8.5%-9.0% for two years in row, the expansion of supply failed to catch up that of demand, sending the inflation rate upward. Thus, the economy has taken on an aspect of overheating. The Reserve Bank of India (the central bank) raised the cash reserve ratio (CRR) by a total of 1.5% to 6.5% between December 2006 and April 2007 (Graph 4). The possibility of a further rate hike cannot be ruled out, depending on the trend of prices in the future. JCR holds that the Indian economy will begin moderately decelerating due to the monetary tightening, with the growth rate slowing down to the 7% level in FY2007.

1.2 Tasks to be addressed in realizing sustainable economic growth; Medium-term outlook

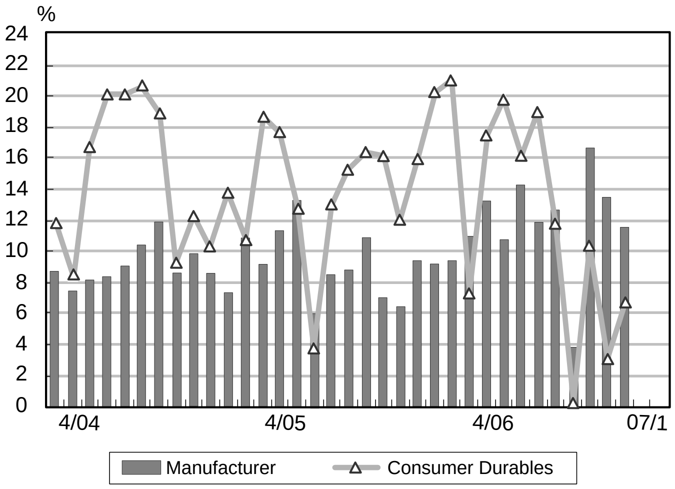
In a medium-term perspective, JCR considers that a high 9% growth rate as envisaged by the government in its 11th five year plan will not be easy to attain given the following factors: (a) the agricultural sector, which accounts for about 20% of GDP and 60% of employment, is vulnerable to

Graph 1. Real GDP Growth Rate Contribution by Industry



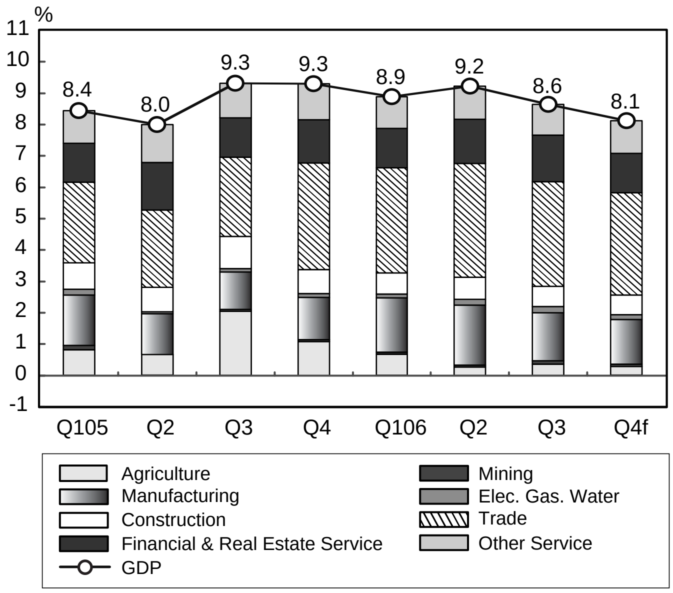
Source: Central Statistical Organization

Graph 2. Trend of Monthly Production Index



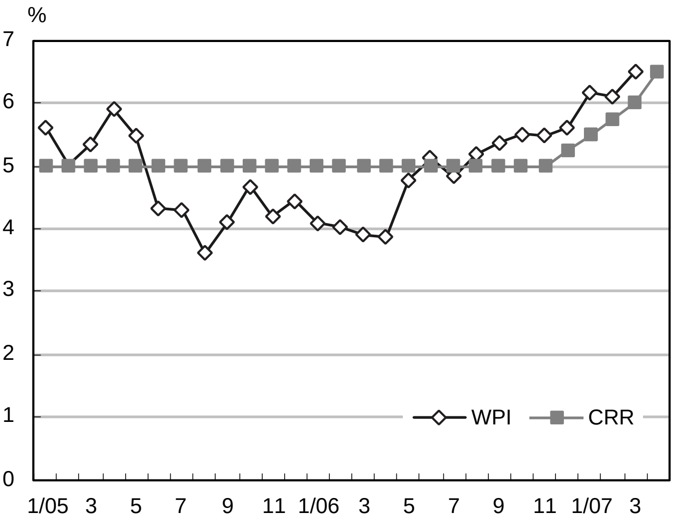
Source: Central Statistical Organization

Graph 3. Quarterly Real GDP Growth Rate Contribution by Industry (Year-on-year)



Source: Central Statistical Organization

Graph 4. Trend of WPI and Cash Reserve Ratio (CRR)

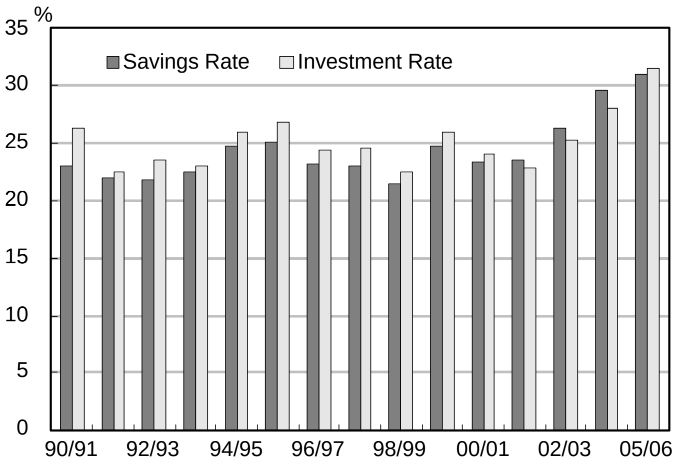


Source: Central Statistical Organization

weather conditions, (b) the infrastructure bottlenecks remain to be resolved, (c) a structural fiscal deficit, (d) a bloated and inefficient public sector, (e) underdeveloped basic education and (f) a chronic shortage of water supply. In addition, in order for India with a huge population to realize sustainable economic growth, it is necessary to increase its production capacity, create new employment opportunities and enhance its industrial structure at the same time. These ought to be realized through sustainable development of not only the service sector but also the manufacturing sector that has a higher capacity to create job opportunities. For that purpose, it will be necessary to shift labor force smoothly from the agricultural sector, which accounts for about 60% of the total employment, to the manufacturing sector. However, the problems unique to the country such as the caste system and a lack of basic education will impede such shift. In this respect, the creation of a special economic zone (SEZ) initiated by the government may prove effective. However, the mounting opposition to the policy in some regions triggered by the acquisition of land from farmers in West Bengal has forced the government to suspend approval procedures for a new SEZ development project temporarily. In early April, in a bid to break the impasse, the government decided to seek resumption of SEZ projects in return for the introduction of regulations including the prohibition of enforced land expropriation and the imposition of a 5,000-hectare ceiling on each development area. Some are critical of the new policy, saying that a small-sized SEZ is inefficient and that proliferation of such zones will have an adverse impact on the public finance. Future developments of the new policy and its effect remain to be seen.

Despite these constraining factors, there are the following factors that support economic expansion: (i) With India's per-capita GDP on a purchasing power parity basis exceeding US$3,000, the rise of middle-class people with greater purchasing power has given a boost to private consumption centering on durable consumer goods such as automobile, (ii) The growing foreign direct investment in the automobile and steel industries led by the expansion of domestic demand is likely to promote the expansion of the Indian economy's production capacity and a further industrial sophistication, (iii) The service sector centering on software has been growing robustly, (iv) As industries such as auto parts, electrical and electronics, pharmaceuticals, textiles and specialty chemicals have enhanced their competitiveness against the backdrop of corporate restructuring and foreign capital inflows, they can expect to increase the export of their products, (v) A rise of the saving ratio amid a high economic growth in recent years is likely to underpin future economic expansion, and (vi) As the ratio of working ages (15 to 64 years old), which stood at 62.9% in 2006, will continue to increase in the long term, the effect of the so-called demographic dividend can be expected (although there are challenges such as employment creation and improvement of basic education). Given these factors, the Indian economy is highly likely to grow faster than 7% per year in the medium to long term (Graphs 5 and 6).

Graph 5. Trend of Savings Rate and Investment Rate



Source: Economic Survey 2006-2007

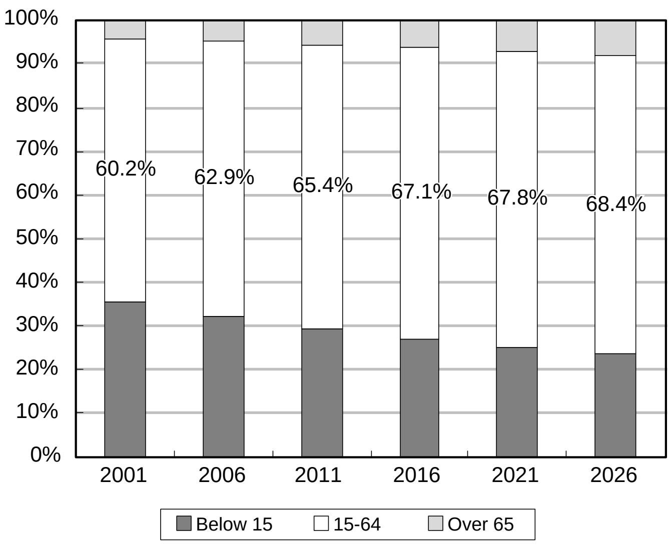
2. Fiscal problems

The improvement of the fiscal position, one of the most important challenges for the Indian government, has been progressing, albeit slowly, in recent years. After reaching a high level equivalent to 9.9% of GDP in FY2001, the combined general-account fiscal deficit of both the central and local governments began declining slowly, falling to 7.4% in FY2005. The fiscal deficit to GDP ratio of the central government has also been on the decrease, dropping to 4.1% in FY2005 and an estimated 3.7% in FY2006. The FY2007 budget plan announced in February 2007 by the UPA government envisaged cutting the ratio further to 3.3% (Graph 7). The budget put the total revenues excluding funds from borrowing at Rs.5,295.7 billion or about 11.9% of GDP. Tax revenues were put at Rs.4,038.7 billion (accounting for 76.3% of the total revenues), up an estimated 16.7% from the previous fiscal year. The planned increase in tax revenues will hold the key to achieving the fiscal deficit target. Annual growth of net tax revenues averaged 19.4% over the three years from FY2003 to FY2005 on strong economic performances. An increase of the same proportions will be well within reach in FY2007.

Meanwhile, the FY2007 expenditures were set at Rs.6,805.2 billion (about 15.2% of GDP), up a substantial 17% from the previous fiscal year. Interest expenses, projected to increase by 8.8% to Rs.1,590.0 billion, are equivalent to 30% of the total revenues excluding borrowed funds. This ratio was extremely high at 48.5% in FY2001. However, it has since been generally on the downtrend (Table 1).

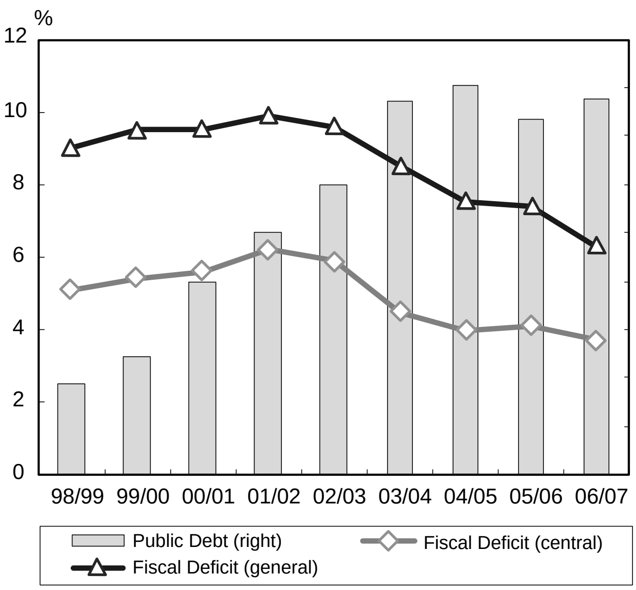
The FY2007 budget continues to pursue improvement of the fiscal position through increased tax revenues on the

Graph 6. Trend of Population Composition by Age



Source: Economic Survey 2006-2007

Graph 7. Fiscal Deficit and Public Debt (as % of GDP)



Source: Ministry of Finance. JCR's forecast strength of a high economic growth. At the same time, it contains measures to address the problems facing the government, such as increasing loans to the agricultural sector, further improvement of education and continued development of the infrastructure. While tax revenues are steadily growing amid a high economic growth, it will be harder for the government to adopt drastic reform and austerity measures ahead of a general election in April 2009. The FY2007 budget mirrors such a situation in India.

In the medium term, however, the government is expected to seek a further improvement of its fiscal position under the Fiscal Responsibility Act. The law had required the government to cut the fiscal deficit/GDP ratio by 0.3% per year to less than 3% by FY2007. The mandatory 0.3% reduction was suspended temporarily under the FY2005 budget. However, the government resumed the required cut in FY2006 apparently with the aim of achieving the target by FY2008 (Graph 8).

3. External balance

Throughout the 1990s, India managed to keep the annual current account deficit/GDP ratio at almost 1.0% by covering its chronic trade deficit with a transfer account surplus centering on overseas workers' remittances. On the back of a strong expansion of services exports led by software, the current account balance turned into surplus in FY2001. However, upbeat oil prices and strong domestic demand centering on private consumption sent imports swelling, which led to a steep expansion of the trade deficit in and after FY2004. As a result, the current account balance again turned into deficit. The current account deficit has since been on the constant rise as the expansion of the trade deficit has accelerated. The current account deficit/GDP ratio reached an estimated 1.8% in FY06 as against 1.4% the previous year. Given the strong services exports centering on software, however, a services account surplus is expected to neutralize the expansion of the current account deficit. At the ongoing pace, the current account deficit/GDP ratio is expected to level off at 1.8% in FY2007 and stay at manageable levels later on (Graph 9).

The country's IT software exports, a focus of global attention in recent years, have been keeping their robust growth. These exports surged 33.3% to US$23.6 billion in FY2005 from US$17.7 billion the previous year. They increased an estimated 30% in FY2006. This strong growth is likely to continue in the years to come (Graph 10).

While FDI is important in financing the current account deficit, it is also indispensable in ensuring sophistication of the industry and sustained economic expansion. FDI inflow turned downward after peaking out in FY2002. However, it began picking up again, growing 38% to US$7.69 billion in FY2005. Its growth pace has been accelerating since the beginning of FY2006. FDI inflow totaled US$5.69 billion in first six months of the year from April to September, up 73.4% year-on-year. JCR will watch how the government can accelerate FDI inflow by improving international confidence through the implementation of structural reforms including deregulation of inward foreign investment and the maintenance of political stability (Graph 11).

India has drastically improved its external balance through a conservative management of external debts and a strong growth of exports since the 1991 foreign currency liquidity

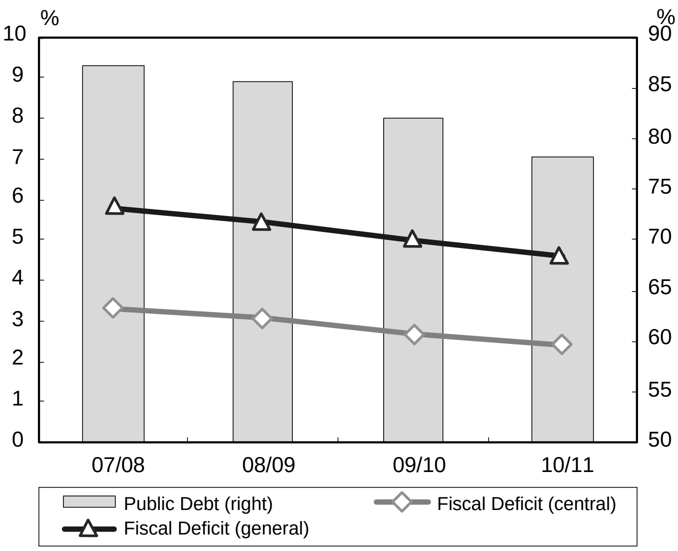
Table 1. Central Government Budget 07/08

(Unit: R bn, %)

	FY06/07 (Estimated Result)	FY07/08 (Budget)	Change (%)
Revenues	4,293.1	5,295.7	23.4
Tax revenue	3,459.7	4,038.7	16.7
Non-tax revenue	773.6	825.5	6.7
Capital revenue	59.8	431.5	621.6
Expenditures	5,816.4	6,805.2	17.0
Non-plan expenditure	4,089.1	4,754.2	16.3
Interest expenditure	1,461.9	1,590.0	8.8
Plan expenditure	1,727.3	2,051.0	18.7
Primary balance	-61.4	80.5	-
Fiscal balance	-1,523.3	-1,509.5	-0.9
Interest expenditure/Revenues (%)	34.1	30.0	
Primary balance/GDP (%)	-0.1	0.2	
Fiscal balance/GDP (%)	3.7	3.3	

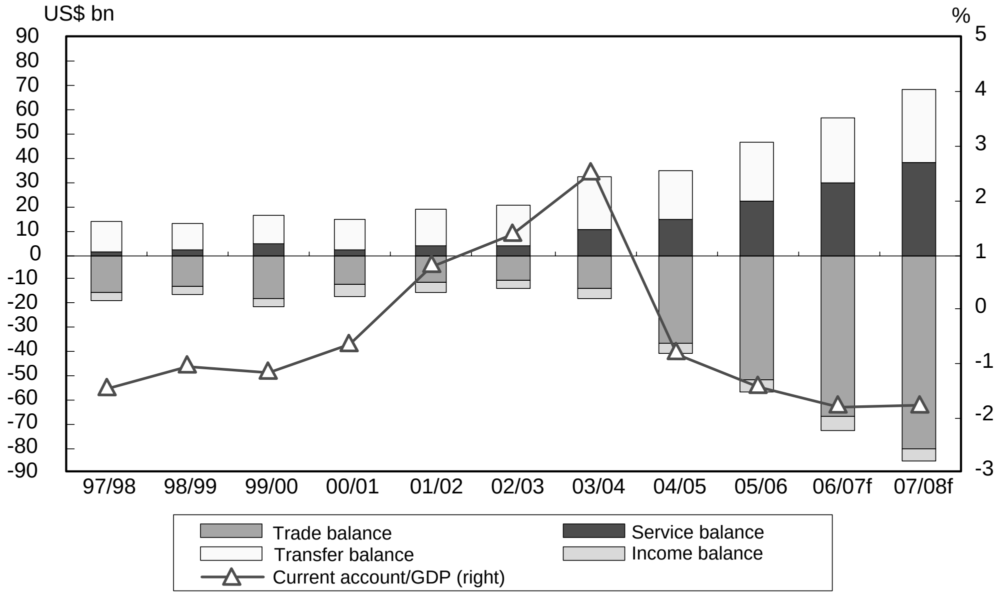
Source: Ministry of Finance

Graph 8. Medium Term Forecast of Fiscal Deficit and Public Debt (as % of GDP)



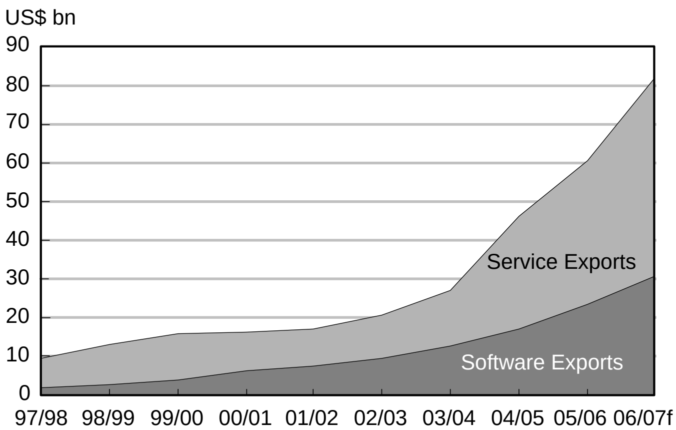
Source: Ministry of Finance. JCR's forecast

Graph 9. Trend of Current Account



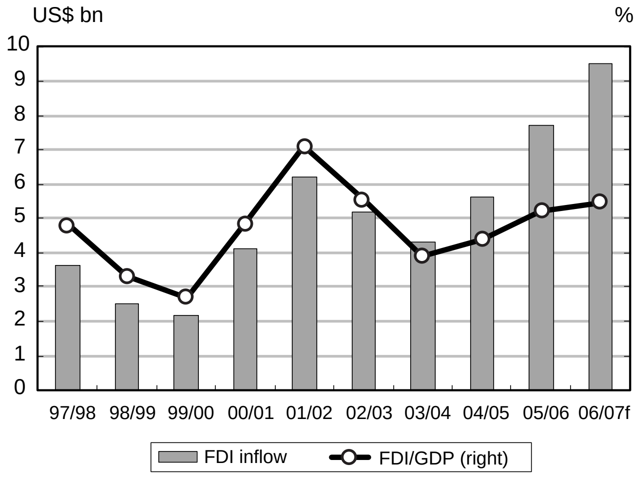
Source: Reserve Bank of India. JCR's forecast

Graph 10. Trend of Service Exports and Software Exports



Sources: NASSCOM, Reserve Bank of India

Graph 11. Trend of FDI Inflow

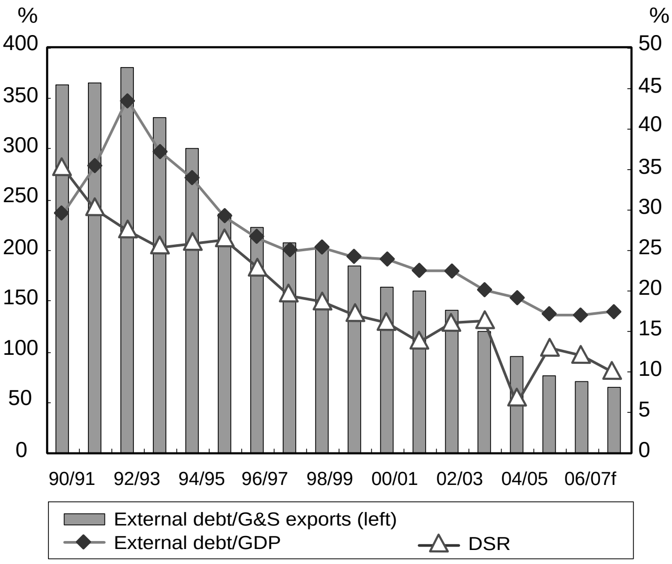


Source: Reserve Bank of India. JCR's forecast

crisis. The external debt/GDP ratio, which climbed to a peak 36.9% in FY1992, turned falling thereafter and dropped to 17% at the end of March 2006. The ratio is expected to stay generally stable in the future. The ratio of external debt to goods and services exports also fell to 75.7% at the end of March 2006 from a peak 381.5% in FY1992, due mainly to a robust expansion of exports. The ratio is expected to continue declining moderately from now on. Meanwhile, short-term external debt has been kept at very low levels, with its ratio to total external debt standing at 7% at the end of December 2006. Similarly, the debt service ratio, which stood at an exorbitantly high 35.3% in FY1990, has improved steadily, falling to 10.2% in FY2005. This ratio is also expected to continue improving moderately (Graph12).

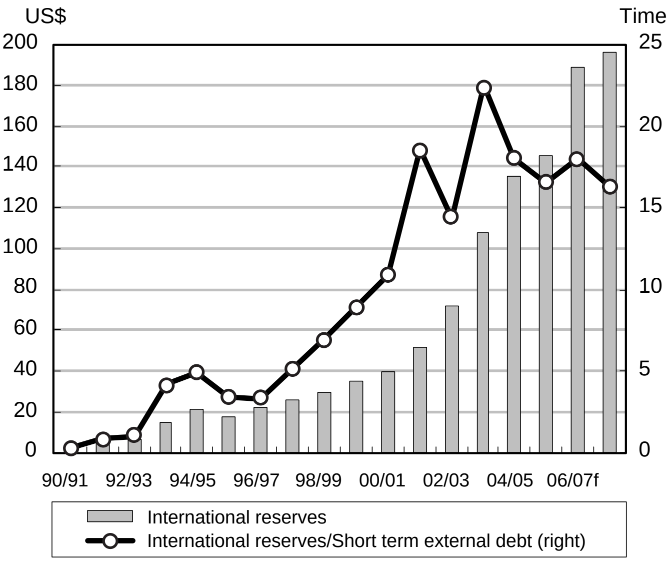
Foreign exchange reserves excluding gold kept increasing in recent years on the back of the current account surplus brought mainly by surging software exports and bigger remittances by nonresident workers in FY2002 and FY2003 and an increased capital inflow thereafter. The reserves stood at US$188.6 billion as of March 16, 2007, ranking India sixth in the world after South Korea. The reserves swelled to a level 22.5 times as much as the short-term external debt at the end of December 2006, a dramatic improvement from a mediocre 0.3 times at the end of March 1991. The ratio has

Graph 12. Trend of External Debt Position



Sources: Ministry of Finance, Reserve Bank of India. JCR's forecast

Graph 13. Trend of Foreign Currency Liquidity Position



Sources: Ministry of Finance, Reserve Bank of India. JCR's forecast

since turned downward due to an increase in the short-term external debt resulting from a sharp expansion of imports. However, it was still kept high at 17 times at the end of December 2006. These indicate that any serious concern over the country's foreign currency liquidity position is less likely in the short run (Graph 13).

4. Political situation

4.1 Singh Administration facing political difficulties

Three years have passed since the coalition government led by the Congress was inaugurated following the general election in April 2004. It has already crossed a halfway point of its term toward the next general election scheduled for April 2009. Leading the coalition government is Mr. Singh, the former finance minister who played a key role in initiating the economic liberalization policy in 1991. The new government has announced its policy to carry out structural reforms "with a human face" geared to pay due consideration to the socially weak. Prime Minister Singh was the finance minister in Prime Minister Narashima Rao's Congress government from 1991 to 1996. He displayed his ability in stabilizing the Indian economy and implementing structural reforms after the foreign currency liquidity crisis that hit the country in the wake of Gulf War I. Incidentally, the main reason for the election defeat suffered by the Rao administration was the widespread dissatisfaction among the poor over its liberalization policy. It is meaningful, therefore, for the UPA government to challenge the old yet new task of striking a subtle balance between merits and demerits that will be brought about by structural reforms and consideration that will be needed for the socially vulnerable. The coalition government's Common Minimum Program attaches much importance to agricultural reforms including an expanded loan facility made available to farmers, job creation, and improvement of education and medical services. Other policies announced by the coalition government included deregulation of equity investment in manufacturers by foreign capital and the introduction of a value-added tax in April 2005. The UPA government has so far produced some tangible results especially in the area of investment promotion, although some remaining reform agenda such as agricultural reforms, revision of the labor act, subsidy reforms and large-scale privatization have been delayed due mainly to protests by leftist parties. Among them are authorization of special export zones, relaxation of the upper limit on foreign equity investment in private airlines and communication companies (from 40% to 49% for the former and from 49% to 74% for the latter), a full liberalization of equity investment in construction, real estate, diamond and coal mining, airport development and oil pipeline development, relaxation of the upper limit to 51% on investment in single-brand retail business, and privatization of small-sized corporations. The VAT has been introduced in 27 of the 28 states except Uttar Pradesh.

The UPA coalition government has 217 seats in parliament. Counting 59 seats of four leftist parties, it narrowly commands a majority of 276 seats in the 545-member lower house. According to opinion polls, despite such a fragile power base, the UPA government maintained relatively higher approval ratings throughout 2006. This was presumably because the public lauded the government's track records of reform initiatives and its stick to the policy of improving the country's relations with Pakistan notwithstanding the repeated terror attacks. However, leftist parties which had opposed the government's reform initiatives, swept the state congressional elections held in West Bengal and Kerala in April and May 2006, gaining a bigger say over the UPA government. Moreover, as mentioned at the beginning, the Congress lost its power in the state congressional elections in Panjab and Uttarakhand (the formerUttaranchal) in February this year, although it managed to keep its strength in Manipur. Thus, the political situation facing the government has grown increasingly severe. Political pundits saw the voter discontent over the higher inflation caused by an economic overheating as one of the main reasons for the election setbacks. Prime Minister Singh, who already faces difficult political management in the coalition government supported by leftist parties outside the Cabinet, may be in for an even harder political maneuvering.

4.2 Advent of an era of coalition government

However, in today's India which has entered into an era of coalition government, tough political maneuvering is inevitably required in a tangle of conflicting interests. In order to understand this, I would like to review the country's political developments in the 1990s. As the Congress went on losing its power after a crushing defeat in the general election in 1989, regional parties and BJP advocating Hinduism gradually gained ground in the central politics. Two governments had collapsed before the Congress came back to power after the assassination of Mr. Rajive Gandhi in 1991. Three general elections were held between 1996 and 1999. These heralded the advent of an era of coalition government in India, where politics had grown unstable amid diversification of political forces. In the general election in April 2004, UPA led by the Congress assumed power after emerging as an unexpected victor. This government is also a coalition that relies on the Communist and other leftist parties which have pledged their non-cabinet support. Thus, politics in India went through what might be called structural changes during this period.

4.3 The background behind the era of coalition government

Analysts point out the following factors as the background behind the drastic changes in Indian politics. In the first place, the realignment of states by language carried out in 1957 paved the way for the emergence of regionalism. Incidentally, India has 16 local official languages in addition to the two federal official languages (Hindu and English). Besides, more than 800 other languages including dialects are actually spoken across the country. Second, political corruption spread during the long rule by the Congress Party and the poor results from its socialistic economic development policies have eroded public confidence in the traditional party. Third, the emerging regionalism gathered momentum in parallel with the decline in the power of the Congress, leading to greater participation by regional parties in the central politics. Fourth, India's deteriorated relations with Pakistan combined with the above-mentioned factors to give rise to a surge of Hinduism sentiments in the Hindu belt in northern India, which in turn has led to the rise of the Bharatiya Janata Party (BJP), a Hinduism party deep-rooted in the region. BJP has rapidly expanded its strength since 1989 with the support of the people who hoped for a stable government. Fifth, the "other backward class" which had not been covered by the successive governments' protective policy, has begun to take part in politics on the strength of its enhanced economic power.

4.4 Challenges for India in an era of coalition government and Singh administration

One may well say that an era of coalition government properly and adeptly reflects the realities of the political and social situation of a country characterized by extremely complicated cultural and social backgrounds. In that sense, it may be fair to say that democracy in India has begun to mature in a realistic way. In the shorter term, however, negative rather than positive aspects may come to the fore. In today's India, deeply mired in a host of complicated factors such as the rise of regionalism, religious diversities, the income gap between the rural and urban areas and problems of the caste, it may be quite natural to think that a difficult political maneuvering is unavoidable whichever party may assume power. Therefore, the more important thing in such a situation is to maintain political stability, that is, to serve out the five-year term of government. And based on such political stability, it is crucial for a government to carry out as many balanced measures as possible, if not 100%, in consideration of the country's political and social realities.

In order for the country with a population of over one billion to perform to the best of its potential, or in other words, to sustain a high economic growth over the medium to long terms, it needs to continue tremendous efforts to overcome its numerous problems. Outstanding among them are its industrial structure heavily dependent on agriculture, structural fiscal deficit, substandard infrastructure, bloated and inefficient public sector, underdeveloped manufacturing industry and insufficient introduction of foreign direct investment, which it needs to make up for lower domestic savings in comparison to those of China. A steadfast implementation of structural reforms is needed to resolve many of the problems. Reforms aimed to break vested interests often bring pains to people and tend to cause political friction. Any administration pushing ahead with reforms needs to have a strong leadership supported by political stability. To carry out reforms at times of recession involves a difficult job of balancing the impact of reforms and economic recovery. This requires the administration to have a very high ability to design and execute policies. One might well say that Indian politics is now faced with a contradictory challenge of having strong political leadership in an era of coalition government.

The UPA government lost power in two of the three states where congressional elections were held in February this year. Another state congressional election is to be held in Uttar Pradesh, a northern state which has the country's largest population of 170 million. At issue will be the rampant inflation and the government's special economic zone policy, which has triggered land problems with farmers in West Bengal and some other states. The Congress is likely to face an uphill battle due to these problems. For the Congress, which is currently a minor opposition party in Uttar Pradesh, it will be next to impossible to wrest power from the incumbent state government. However, if it loses some of its seats, it may have to see its cohesion power eroded in the UPA government. During the two remaining years of its office, the Singh administration will be faced with even greater difficulties, which could force it to push its reform initiatives at an even slower pace.

However, the Singh government has indisputably made a measure of success in its reform policies under a difficult political situation. Its ability to implement policies is not low at all. There is a critical view that the relationship between Ms. Sonia Gandhi, the leader of the Congress, and Prime Minister Singh amounts to a dual power structure. However, it would be more appropriate to see it as a unique system which enables Ms. Gandhi to unite the Congress under the prestige of the Gandhi family and tout more government consideration for the socially vulnerable while allowing Mr. Singh, a capable technocrat, to devote himself to his official responsibility. If so, this system may continue to function effectively, if not perfectly, during the remaining tenure of the UPA government. Meanwhile, leftist parties are less likely to withdraw their non-cabinet support before the next general election slated for April 2009 because they don't want to see the former ruling BJP come back with its Hinduism principles. Given these factors, it is highly likely that the UPA government will serve out its remaining tenure of office.

4.5 India's relationship with Pakistan

On the diplomatic front, the coalition government has basically taken over the policy to improve the country's relations with Pakistan initiated by former Prime Minister Atal Bihari Vajpayee. However, the road in the past was never straightforward. Many terrorist incidents have occurred, including the bomb explosion in Delhi in October 2005, the one in a Hindu holy land in Uttar Pradesh, northern India, in March 2006, the train explosion in the western commercial city of Mumbai in July 2006, the bomb attack near the mosque in the western state of Maharashtra in September 2006 and the blasts on the train running between Delhi and Pakistan's Lahore in February 2007. However, the governments on both sides have basically kept a self-composed approach and maintained the momentum of peace talks. It may be conjectured that a mix of political and economic factors has led the governments on both sides to think that it would better serve their national interests to avoid military conflicts and pursue mutual benefits through dialogue and closer economic relations. These factors include a major improvement of India's relations with the United States, Pakistan's long-time mentor, against the background of China's economic and military rise, the stalemate of the Bush administration's hard-line policy against Iraq as well as the surge of the Indian economy. In any case, while there may be some twists and turns including tough negotiations over the complicated Kashmir issue and resistance from extremists, it is expected that both governments will basically maintain their rapprochement policy.