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mint

ARVIND VIRMANI

Nothing to despair, but don't be complacent

LEAD

# Having survived the worst, the economy must now reform to perform

By Anil Padmanabhan
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New Delhi:
The basic tenor of the latest Economic Survey is cautiously optimistic and projects growth in this fiscal at 7%, which is a marginal, yet significant, recovery after the slowdown in 2008-09 that saw it drop to 6.7% from an unprecedented level of 9% plus in the previous three years.

The finance ministry, which scripts the document, has signaled an economic recovery from the third quarter of this fiscal year and maintains that the country could recover its high growth momentum provided it was able to successfully set out and execute a time table for second generation reforms relating to energy pricing, fiscal deficit, tax structures, public distribution system and education.

It has however presaged this on the assumption that the country would have a normal monsoon, a clear picture of which will emerge only by the end of July, and the United States economy bottoms out by September, eliminating the risk of any fresh external sector shocks. The downside of this risk is that growth would drop to 6.25%, which by any metric in the current global context is still impressive, but not enough given the vaulting ambitions of the UPA government to guarantee inclusiveness.

The Economic Survey, which is the annual post mortem by the finance ministry of the preceding fiscal year, was tabled in Parliament on the first day of the month long budget session, also the first season for the Congress-led United Progressive Alliance in its second tenure at the center. It is an important document that sets the context for the Union Budget due on 6 July and at the same time reflects the current thinking within finance ministry, particularly with respect to its assessment of the macro economic prospects.

The central ethos of the Survey was aptly summed up by Arvind Virmani, the chief economic advisor, who's term, due to end on 30 June, has been extended to 30 September, when he told Mint in an interview, "There is nothing to despair and there is nothing to rest on your laurels. There will be things that you are going to have to do.That is the message i am trying to send out."

The ministry is apprehensive that the hard lessons emerging from the unprecedented global macro economic shock, first the runaway rise in international crude oil prices and the subsequent financial meltdown, may be ignored and that the economy would gravitate to slower growth trends.

Such a circumstance, it fears, will not only nip the economy's potential, but at the same time jeopardise the entire welfare spending programme. Part of the reason that the UPA in its previous five years was able to ramp up welfare spending, including organising the record Rsxx crore farm loan waiver, was because the rapid growth in the economy ensured a spurt in tax revenues.

"High growth is critical to generate the revenues needed for meeting out social welfare objectives on a sustained basis and ensuring inclusive growth," the Survey said.

This presaging of the government's ability to fight poverty on a high growth trend is significant. The Survey does so by drawing a direct corrollary between aggregate poverty and aggregate consumption. And, thereby it argues that growth of aggregate consumption is a sufficient condition to reduce overall poverty.

The fact that it is a reiteration of what was laid down in President Pratibha Patil's address to the first session of the 15th Lok Sabha, suggests that it is now a key part of the government's economic ideology. And since return to high growth rates can only be managed by easing infrastructure bottlenecks, reducing vulnerability to energy shocks and return to fiscal prudence, all of which need radical policy overhaul, the UPA has linked its pursuit of inclusiviness with another round of economic reforms. It will also be politically easier to defend.

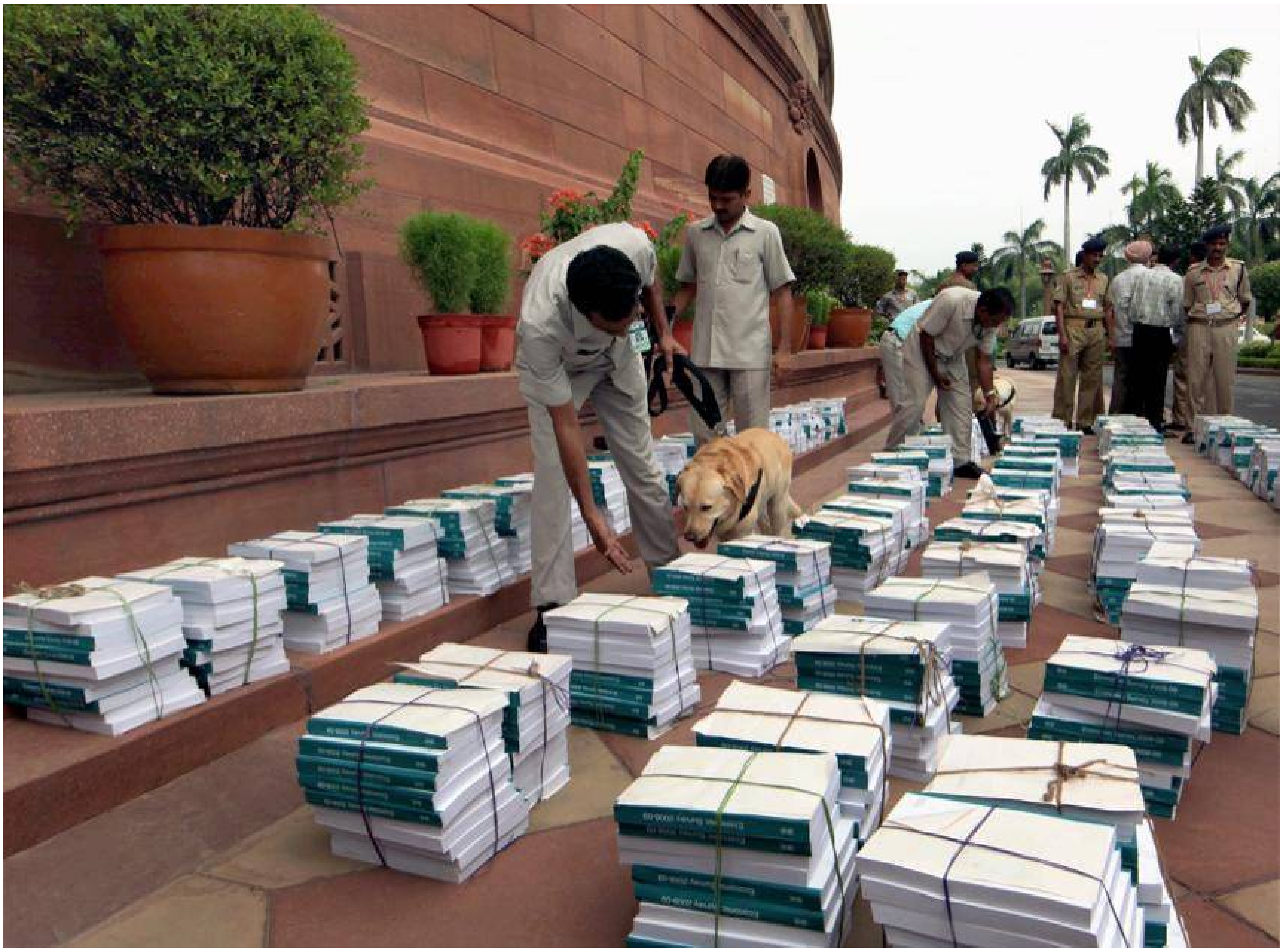
While it is likely as Virmani pointed out in the interview that finance minister Pranab Mukherjee would set out the fiscal correction measures in the Union Budget, the UPA has through statements of its various cabinet ministers in their 100 day agendas indicated that the government would not shy away from tough decisions.

The overview also sets out the vulnerability of the Indian economy, given its growing global linkages as the country progressively brought down its tariff barriers, but with a homily that economic "shocks" should not be used to reverse the country's economic stance. According to it, the risks associated with high growth should not be a deterrent. Instead, there should be a strong policy response that would revive growth prospects in the economy.

Among the immediate areas of concern, and hence a likely policy focus area, is the sharp dip in the growth rate of private consumption and of investments. It attributes the former to a combination of the erosion in value of real estate and equity, job losses, cut back in consumer credit and loss of consumer confidence. According to the Survey investment has slowed down in the economy due to the credit squeeze and spurt in borrowing costs.

In the final analysis it is clear that the Economic Survey in its prognosis of the last fiscal and the first two months of 2009-10 concluded that the worst is behind for the Indian economy. Even if the underlying assumptions do not pan out as expected, the economy will not plunge precipitously. But that is only part of the conclusion. The kicker of this year's Survey is its very candid assertion is that the country has to undertake some very contentious economic reforms, if it has to avoid the risk of falling back to a low growth cycle. By linking it to the ability of the government to manage its inclusive strategy, it has also provided the political wherewithal. But the big question is whether the UPA has the political will to bite the proverbial bullet.

THE GLOBAL FACTOR



FOREIGN TRADE

# Time to shape up and ship out

By Asit Ranjan Mishra
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NEW DELHI

The outlook on the external trade front for India in 2009 is not very encouraging and it is too early to predict a turnaround on this front, the government said in the Economic Survey 2008-09.

India's exports which showed resilience till August 2008 succumbed to pressure from lowering import demand by developed nations post the Lehman Brothers meltdown which pushed the world towards an economic recession.

During 2008-09, India's merchandise exports in balance of payments terms rose 5.45% to $175 billion compared to 29% growth registered in the previous year. Imports also decelerated significantly during the year growing only at 14.3% in BoP terms compared to a growth rate of 35.25% in 2007-08.

As a percentage of GDP, exports were 15.2% and imports 27.1% in 2008-09 (April-December) as comopared to 13.5% and 21.8% respectively during 2007-08.

The survey said that the directional pattern of India's trade has changed during the decade. The share of the US, the largest trading partner, declined by 1.5 percentage points to 10.1% in 2007-08 due to the global recession originating in the US. The share of China, the second largest trading partner, increased to 9.2% in 2007-08 from 4.9% in 2003-04. China became the largest trading partner of India in April-February 2008 with trade share of the US falling drastically by 2 percentage points compared to 2007-08.

During 2008-09 (April-February), India had a trade surplus with US, UK, Singapore, Brazil and Hong Kong, the largest trade deficits were with Saudi Arabia and China. In terms of export destination, the US continued to be the principal destination accounting for 12% of India's total exports in 2008-09 (April-February) followed by UAE (10.8%), China (5.1%), Singapore (4.8%), Hong Kong (3.7%) and UK (3.6%). Region-wise, over half of India's exports were to Asia (including ASEAN), up from around 40% in 2001-02.

The survey maintained that though India has been diversifying its exports, there is plenty of scope to diversify into sectors where global demand is high and increasing.

While the survey said India needs to desist from any protectioinist tendencies in the light of the global recession, it defended the increase in import tariffs on certain items in November and December 2008. "In no case has the customs duty/CVD rate been increased beyond the rate(s) prevailing earlier. The increase in import duties, if any, has only been to the extend of restoring status quo for items where reductions were made to combat inflationary pressures," it said.

The survey also emphasised the need to have a low tax regime with few exemptions with each exemption notification having a sunset clause triggering automatic review of exemptions.

To make exports competitive, the survey called for continuation of the reduction in customs and excise duty, streamlining of existing export promotion schemes and giving special attention to export infrastructure along with rationalisation of port service charges.

India remained an attractive destination as net FDI flows increased to $17.4 billion in FY09 from $15.4 billion a year ago. The comfortable foreign exchange reserves position also alleviated the impact of global crisis on the external sector of the economy, the survey said.

The balance of payments data for FY09 by the Reserve Bank of India on 30 June showed despite higher net invisibles surplus of 7.7% of GDP, the large trade deficit of 10.35% of GDP led to a higher current account deficit of 2.6% during the year.

Net capital flows declined to $9.1 billion in 2008-09 compared to $108 billion in 2007-08. Under net capital flows, all the major components except FDI and NRI deposits, showed a decline during 2008-09. FIIs withdrew $15 billion during 2008-09.

However, the survey maintained that despite the setback, the BoP situation of the country continues to be resilient.

India improved its rank in the world merchandise exports from 28th position in 2006 to 26th position in 2007 and maintained the same in 2008. In commercial services exports it has improved its rank from 10th position in 2006 to 9th position in 2007 and maintained the same in 2008. China ranked 7th in commercial services exports in 2008. Commercial services include three broad categories namely transport, travel and other commercial services.

## CONCERNS


CHALLENGES PERSIST

# Trials foreign and domestic

BY SANJIV SHANKARAN
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NEW DELHI

External shocks are the biggest risks the Indian economy faces in the medium term, and insurance against them has to come in the form of reforms to fiscal policy, financial sector, energy policy and investment climate, the 2009 Economic Survey said.

To reform fiscal policy, tax and expenditure policies need to be restructured to act as shock absorbers and enhance transparency, according to the section of the survey that identifies risks and challenges to the economy.

Loose policies in the past "reduced the headroom for short-term counter-cyclical fiscal policy" when India was hit by fallout from the implosion of global financial intermediaries last year, said the survey. Moreover, introduction of taxes on transactions and expenditure in the recent past such as the fringe benefits tax (FBT) reversed moves towards a simpler system.

"All our ills in the last two years are related to external shocks," D.K.Joshi, principal economist and director, Crisil Ltd, said.

According to Joshi, the survey should have attempted to prioritise the sequence of reforms even if it is a difficult task. Without prioritisation, the government would spread itself too thin, he said.

Industry lobby group Confederation of Indian Industry (CII) supported the survey's stand on taxes. "Tax reforms such as the removal of inefficient taxes such as the FBT, CTT (commodities transaction tax) and STT (securities transaction tax) have also been proposed by CII. Removal of surcharges and cesses and merging them with the direct tax rate will also help simplify the process of filing taxes," it said in a statement.

The finance ministry's chief economic advisor, Arvind Virmani, in an interview to Mint said the reforms were essential as complacency could undo the benefits of fast-paced growth over the last few years.

The emphasis on reform is linked to possible external shocks that might stall a recovery in economic growth, which has slowed in the wake of a global recession. The recent rise in the price of crude oil and other commodities may adversely affect recovery, the survey said.

The pace of India's growth recovery is also linked to the revival of the global economy, particularly the US.

According to the survey, if the US economy bottoms out by September, there is a good possibility of the Indian economy repeating its 2008-09 performance, i.e. around 7% growth, assuming a normal monsoon. The survey said the growth forecast was subject to a fluctuation of up to 0.75% either way, an indication, according to Virmani, of the extent of economic uncertainty.

In the wake of the rise in crude prices, reforms in energy policy was identified as a key policy challenge. The current method of largely insulating domestic consumers from an increase in international crude price means a transfer of a form of tax abroad as long as consumption increases, the survey said. The subsidy for domestic consumption is borne by the government balance sheet and adds to below-the-line fiscal deficit.

The survey's recommendations on energy reforms were not restricted to petroleum and its downstream products. Coal, which is the input for about 70% of India's power supply, was identified as a sector in need of reforms.

Financial sector reforms need to be a priority area for the government as the current fragmented nature of credit markets also has a negative impact on the effectiveness of monetary policy, the survey said.

Domestic financial sector reforms are also likely to act as a cushion against external risks stemming from the crisis in developed markets' financial sector.

Among the risks to the Indian economy that the survey identified were a reduction in the availability of risk (equity) capital for companies worldwide and a slowdown in medium-to-long-term capital flows.

Among the financial sector reform measures suggested by the survey to counter the fallout of a global financial crisis are the introduction of exchange-traded credit derivatives, banking reforms, making the Securities and Exchange Board of India the sole entity overseeing financial market regulations and introducing a government guarantee mechanism to boost infrastructure lending.

Some of the reforms suggested in the survey have been proposed before, but were not implemented by the governments of the day. The United Progress Alliance's victory in the April-May general election with a bigger majority than it won in 2004 has sparked expectations that stalled reforms may finally be carried out.

"This time there is a stable government and it has shown some resolve in the last month. This gives some confidence some reforms will get carried," Crisil's Joshi said.

Among financial sector reforms suggested to improve the investment climate are legislations to give statutory status to India's new pension system and its regulator, Pension Fund and Regulatory Development Authority (PFRDA). Finance ministry officials had earlier told Mint that the pension legislation was going to be one of the legislative priorities for the government.

Insurance reforms, including the move to enhance the ceiling on foreign direct investment to 49%, was kicked off by the last government, and the current government would have to continue with the process.

Another reform suggested is the establishment of a regulatory body for the transport sector, including railways, highways, ports and airports. Transport is one of the key components of India's infrastructure and an area where the government has tried to boost investment.

To complete the reform package to enhance investment environment, the survey has called, yet again, for a reform of bankruptcy laws to "ensure speedy and effective bankruptcy so as to save/preserve assets for altenative uses."

# FINANCIAL MARKETS

BANKING

# Central bank keeps supply liquid and solid

BY ANITA BHOIR, RAVI KRISHNAN AND ANUP ROY

MUMBAI

There was not a single day in March this year when the Reserve Bank of India (RBI) had to infuse liquidity in the financial system, the first such month in the last few years.

It was quite a feat for a central bank that a mere months earlier was frenetically pouring money into a financial system that was shaken and stirred by the sudden outflow of foreign capital from the Indian stock market, following the September 2008 bank collapse of investment bank Lehman Brother Holding Inc in New York. Credit became scarce and interest rates shot up before RBI stepped into calm the domestic money markets.

Liquidity was the over-arching theme in the Indian financial markets in 2008-09. Too much of it had pumped air into an asset bubble and fanned inflation in the first half of the year, forcing RBI to push up interest rates. Then there was too little of it as the full impact of the global financial crisis hit India, forcing RBI to ease policy.

While the Economic Survey 2008-09 commended the government and the central bank for the way they handled a year of extremes, it also cautiously called for further reforms in the financial system.

Thus, it called for a "phased increase" in foreign direct investment limits in banks and "greater entry" of foreign banks, it also mentioned the need for "tighter regulation of investing banks and other foreign entities". And even as the survey reiterated the need for more financial and commodity derivatives in India to help companies manage risks, it suggested that these products should be traded on exchanges rather than through private deals. Deals done on exchanges are easier to police than those struck privately.

"The measures initiated on the monetary front were in the nature of an accommodative policy to ensure that there were no liquidity constraints in the economy," the survey noted. "Coupled with the expansionary fiscal policy, the initiatives have had a favourable impact on domestic monetary, real and financial sectors."

"Last year was a year of contrast," said Harihar Krishnamurthy, treasurer of the Indian unit of South Africa-based First Rand Bank. "The story of the first six months got completely reversed in the last six months. The inflation and growth management priority shifted to liquidity management."

But this was not before the economy and the financial sector suffered a lot of pain in the October-December quarter. The liquidity squeeze stymied credit flow to the industrial sector and together with other factors such as a slowdown in global economic growth and volatility in commodity prices led to a sharp decline in the rate of economic growth in India. Stock markets crashed, banks wouldn't lend to each other or to companies, and people rushed to redeem money from mutual funds causing some to them to go out of the money or trade below par value.

By September 2008, liquidity was already tight in the system as the RBI fought against inflation that had risen to a 16-year high of 12.91% in August. In the year leading up to this, the central bank had repeatedly raised interest rates and the amount of deposits that banks had to keep with it, known as the cash reserve ratio.

However, the tight money scenario worsened considerably following the collapse of Lehman Brothers. The world and its bankers started discovering the extent of leverage and toxic debt the financial system was mired in. Investors started to pull out money from shaky asset classes - such as equity and corporate debt to squirrel it away in risk-free securities such as government bonds. Indeed, the spread between the yields on the five year corporate bond and similar maturity government paper had moved in a range of 133-223 basis points between April-August 2008, the survey points out.

"There are a few nagging issues that need to be settled (in the corporate bond market)," said Alpana Dave, head of corporate bond trading at ICAP India Pvt Ltd. "The interests are still with the AAA rated (highest quality) papers and even AA papers are hardly traded. There is no liquidity in the market and there is absolutely no market maker, unlike the g-sec (government securities) market."

In India, the largest category of investors, the foreign institutional investors sold some Rs41,216 crore of equity in calendar year 2008, according to the survey.

Consequently, the stock markets went into a tailspin. The Bombay Stock Exchange's Sensex, the most widely tracked index in the country, lost about 52% during the year. Mutual funds saw their collective assets under management dip sharply to Rs4.13 trillion at the end of 2008 from Rs5.5 trillion a year earlier.

The crisis affected Indian firms' ability to raise funds abroad and domestically and constrained the banks' lending ability here. The number of companies that raised money in the equity markets in 2008 fell to 37, from 100 the previous year. Overall Rs49,485 crore of fresh equity was issued compared to Rs58,722 crore a year earlier, according to the survey.

Though bank credit to the commercial sector witnessed strong growth in the first half of the year, it decelerated particularly in the second half of the year. For the full year 2008-09, bank credit to the commercial sector expanded by 16.9%, compared to a 21% growth the previous year. In absolute terms, bank credit decelerated to Rs4.08 trillion in 2008-09, compared to Rs4.3 trillion in 2007-08.

"It started with the collapse of Lehman. Both the currency and liquidity pressure (made) banks refrain from lending," said Mridul Saggar, associate director and chief economist at Kotak Securities Ltd. "Private and foreign banks have become risk averse. Fear of being hit by a non performing loan cycle kept them away from the market."

The rupee was not spared either. By March 2009, the local currency had reached 52 a dollar, a record low, as foreign investors continued to pull out of India. RBI had to sell dollars to prop the domestic currency. India's foreign reserves, which were $316 billion in May, subsequently came down to $250 billion by year-end.

As the situation worsened throughout October, banks soon had to start borrowing money from RBI though its so-called liquidity absorption facility, or LAF, window. On October 10, banks had to borrow a whooping Rs92,000 crore from RBI when the interest rate in the overnight interbank market jumped to 20%. On average, banks borrowed Rs43,000-46,000 crore daily during September and October. An additional Rs40,000 crore was released by bringing down the banks' bond holding obligation to 24% of their deposit liabilities, from 25% earlier. However, banks continue to hold more bonds than their minimum requirement.

Since September, RBI reduced banks' cash reserve requirement by 400 basis points, and brought down the repo and reverse repo rates, or the rates by which it injects and sucks out liquidity from the system, to 4.75% and 3.25% from 9% and 6%.

All these various measures meant that some Rs 4.22 trillion was released in the economy, the RBI estimates. It has also helped push the economy back on the growth track.

As compared to recession-stricken developed countries, the Indian economy has merely seen growth moderate in 2008-09, the survey noted. "On a preliminary assessment, the economy evinces early signs of turnaround," it summed up.

# DOMESTIC CONSTRAINTS

FUNDING ISSUES

# Big plans, big bucks, big risks

BY RAHUL CHANDRAN & K.P. NARAYANA KUMAR

NEW DELHI

The Economic Survey 2009 expressed concern over the sourcing of funds for India's massive infrastructure development plans, saying that the Rs20.56 trillion in projected investment over the five years ending 2012 looked daunting.

Sectors such as air transport and telecom, which were major recipients of external commercial loans, witnesssed a decline in fund inflows in 2008-09 as the US and Europe slipped into recession and domestic economic growth slowed.

Equity financing suffered as well, with infrastructure companies raising less money through public and rights issues in 2008-09, mirroring the overall trend across sectors. Public share sales and rights issues—sale of stock to existing shareholders—fell from Rs87,029 crore in 2007-08 to Rs14,720 crore in 2008-09.

The survey estimated a shortage of Rs1.62 trillion in debt funds over the 11th Plan period (2007-12).

Interestingly, it said that while bank credit grew from Rs30,122 crore in 2006-07 to Rs61,745 crore in 2007-08 (and Rs66,770 crore in 2008-09), investment by public sector insurance companies fell 64% from Rs27,656 crore to Rs8,309 crore in 2007-08.

Overall, the survey said investments in the sector by both public and private sector insurance companies fell from Rs28,906 crore in 2006-07 to Rs10,399.8 crore in 2007-08.

Insurance industry executives, however, said their investments had increased.

"Our preliminary data, which is unaudited, shows infrastructure spending increased by Rs17,000 crore in 2008-09 to Rs1.12 trillion. Investments stated in the survey could be low because equity investments were included and valuations are lower now," said S.B. Mathur, secretary general of Life Insurance Council, an umbrella body.

Analysts said any decrease in investment numbers represented merely a pause. "Even in 2008-09, the fixed investment to GDP (gross domestic product) ratio went up. It (infrastructure investments) may not be proceeding at the pace it needs to. There is definitely a pause. Maybe they will have to shift it (investment projections) from the next five years to the next seven years," said D. K. Joshi, principal economist for ratings firm Crisil Ltd.

Joshi added that the big drawbacks for the sector, given the context of the global slowdown, was the level of risk that was shared between the private sector and the government while developing projects through public-private partnerships.

The United Progressive Alliance administration follows a policy of pushing private sector investments in infrastructure, to free scarce budgetary resources for spending on social sectors such as health and education.

Investment in infrastructure, especially roads, was affected last year, with companies staying away from some projects that were up for bidding.

"If the sector is not completely derisked then the state will have to underwrite the risk," Crisil's Joshi said. "There is a power shortage in India. I would rather have electricity than not have electricity and pay a lesser bill."

Individual sectors also showed the effects of the slowdown.

The Indian Railways faced a tough year in 2008-09. Its growth rate during the year was 4.9%, down from 9% in the previous fiscal. The slump was largely on account of freight loading having slowed in the iron ore and foodgrain segments. While iron ore loading slumped 4.6%, foodgrain transportation through rail also fell 10.7%.

However, railway passenger traffic grew by 6.9% compared with 5% in the previous year.

Similarly, the ports sector too faced a demand crunch during the same period. In 2008-09, the cargo handled by major ports registered growth of 2.1% against 13.9% in 2007-08.

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OVER THE HUMP

# No green shoots yet in farm sector

BY K.P. NARAYANA KUMAR
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The Index of Industrial Production grew at only 2.4% in the year ended 31 March, compared with 8.5% in the preceding year, the Economic Survey 2009 said.

"The industrial sector witnessed a sharp slowdown during 2008-09 as a consequence of successive shocks, the most important being the knock-on effects of the global financial crisis," the survey said. "The pace of slowdown accelerated in the second half of 2008-09 with the sudden worsening of the international financial situation and the global economic outlook."

Growth in mining, manufacturing and electricity generation slumped to 2.3%, 2.3% and 2.8% in 2008-09, from 5.1%, 9% and 6.4%, respectively, in the previous financial year.

However, "there were positive signs that the Indian industry may have weathered the most severe part of the shock and is now moving towards a recovery," the survey said.

Some of the positive signs, it said, are the recent upturn in power generation, improvement in cement despatches and rise in bank credit. The sustained inflow of foreign direct investments (FDI) also points to foreign investor confidence in the Indian economy, especially Indian industry, the survey said.

The period between January 2006 and July 2008 saw persistent increases in the price of crude oil.

The price rise in other commodities, particularly metals and ores, from the second half of 2006-07 to the second half of 2008-09, also had its effect on the cost side of the manufacturing sector, it added.

Cost due to consumption of raw materials rose by as much as 38% and 44% in the first two quarters of 2008-09, compared with 16% and 12%, respectively, during the same quarters of the previous year.

Beverages and tobacco, and machinery and equipment posted the best annual growth figures at 15.6% and 8.7%, respectively.

Wood products, jute textiles, food products, leather products and metal products posted the worst growth rates, showing declines of between 10.3% and 4%.

In the farm sector, which provides livelihood to around 60% of the country's population, growth fell to 1.6% in 2008-09, compared with nearly 5% growth in the year ended 31 March 2008.

The fall in production of non-food crops, such as oil seeds, cotton, sugarcane and jute, contributed to the reduced growth.

The survey was concerned over declining investments in the agriculture sector.

The survey suggested doing away with the ban on futures trading on rice, sugar and lentils.

India's food subsidy bill increased from Rs31,260 crore to Rs43,668 crore on selling rice and wheat below cost to poor families.

"In 2008-09, most kharif crops except paddy were bad. Oilseeds, maize, sugarcane and pulses saw fall in production. Because of expecatation of a deficient rainfall, agricultural growth is expected to fall in 2009-10 also although it is a little early to say that," said S. Raghuraman, head of trade research at **Agriwatch**, a Delhi-based research outfit in agri-commodities.

*Utpal Bhaskar contributed to this story.*

# FISCAL PRESSURES

**DEFICIT WORRIES**

# Ends must meet

By Kathleen Brooks
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NEW DELHI

The Economic Survey for 2008-09, released Thursday, proved right fears that India's populist economic policies of the recent past would increase the country's fiscal deficit. It revised up the fiscal deficit for 2008-09 to 6.2% of gross domestic product or GDP.

The fiscal deficit is the total amount borrowed in the course of the year by the government to bridge the gap between its income and expenditure.

In 2007-08, India's fiscal deficit was 2.7% of GDP.

The survey proposes measures to reduce the deficit to 3% of GDP in the short-term, the target originally proposed by the Fiscal Responsibility and Budgetary Management Act. The long-term proposal was more radical, calling for a 0% deficit target on a cyclically adjusted basis. That means that when the economy is expanding there should be no deficit.

James McCormack, head of Asia-Pacific sovereign ratings for Fitch, the credit rating agency, said that a 0% target was "not plausible" for India, but 3% is a "reasonable target" in the medium-term. "This is a realistic time limit," said McCormack. "It won't be possible to bring this deficit down quickly."

Fitch reduced the outlook for India's local currency to negative from stable at the end of 2008, on the back of concerns about the fiscal deficit. The Economic Survey, which is a roadmap for future economic policy, suggested tax simplification, subsidy reform and divestment as remedies for India's fiscal problems.

McCormack said he was happy that the survey addressed some of Fitch's concerns. "The subsidy issue is the most critical for us," said McCormack, who is based in Hong Kong. The survey has identified subsidies as a major hurdle in India's ability to address the fiscal deficit and has suggested reform for petrol, fertilizer and food subsidies. On Wednesday the government announced it would raise petrol and diesel prices by Rs 4 and Rs 2 per litre, respectively. But this alone will not be enough to reduce the deficit.

Like many other countries, India has responded to the global economic crisis and consequent slowdown with fiscal stimulus packages. That's meant more government spending. India has announced two such packages already and the survey did not rule out further stimulus packages if growth does not bounce back quickly. This means that revenue will be key to reducing the deficit in the medium term.

The survey proposes a range of revenue-generating measures including revitalizing the divestment program, which would see the government selling 5-10% stakes of profit-making state-owned companies. Reports suggest this could raise as much as Rs 25000 crore . Another proposal recommended by the survey is the auction of third generation or 3G spectrum or radio waves.

For long-term fiscal sustainability the survey suggests establishing the Goods And Services Tax from April 1 2010, as well as simplifying tax collections and the introduction of a new Income Tax code.

India's credit rating is currently one notch above junk status at BBB-. McCormack says that even with the proposals included in the economic survey the negative outlook remains the same.

"The critical question is when growth resumes, will the government implement these measures (put forward by the economic survey) to reduce the fiscal deficit?."

McCormack says that more important than the economic survey and the budget will be the recommendations for fiscal consolidation that will be released by the 13th Finance Commission in October.

"We don't expect much from the budget because it is dealing with this year's problem, which is growth," said McCormack. " We're waiting for the 13th Finance Commission to deal with the medium-term issues."

Ajay Shah, a senior fellow from the National Institute of Public Finance and Policy (NIPFP), says that he hasn't even read the Economic Survey, and does not believe that the survey should be "endowed with the significance people give it."

A paper released by NIPFP in June 2009 estimated the consolidated fiscal deficit, which includes that of the states and the centre, at 8.09% of GDP for 2008-09. It termed India's fiscal problems structural, not cyclical, which is at odds with the survey. The NIPFP said only strict fiscal discipline and subsidy reform can reduce the deficit.

SOCIAL SECTOR

PLUGGING LEAKS

# Scams hinder schemes

BY SANGEETA SINGH
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NEW DELHI

With development of social sector clearly being a focus area with the United Progressive Alliance or UPA through out its last term spending on the sector has gone up by 8% in six years since 2002-03.

UPA assumed office in 2004. It was voted to power again in May.

According to the Economic Survey 2008-09, released on Thursday, the Central government expenditure on social services as part of total expenditure (Plan and non Plan) has increased from 11.23% in 2002-03 to 19.44% in 2008-09.

Expenditure on social sector as a percentage of GDP in 2008-09 was 6.72% against 6.43% a year before that. Education comprised 3% of the social sector expenditure in 2008-09.

UPA in its last term came up with several schemes and upgraded some existing schemes which the survey has highlighted. These schemes include Bharat Nirman, NREGS and Total Sanitation Campaign.

The Survey however recognised leakages in social sector schemes such as the National Rural Employment Guarantee Scheme or NREGS. For this, it has suggested an Internet accessible public accountability Information System providing information about the funds allocated and the expenditure made along with the name of the beneficiary. This needs to be accompanied by a smart card.

It further suggests that the Unique ID or UID initiative taken by the government will help tap leakages.

Under Bharat Nirman a Rs1.76 trillion time bound rural infrastructure programme focus on rural electrification, irrigation, drinking water, housing, roads and telephony , total allocation in the interim budget 2009-10 has increased by 30% against budget 2008-09.

Talking about the success of Bharat Nirman the survey says that 2.14 km of roadworks have been completed under Pradhan Mantri Gram Sadak Yojana or PMGSY by March 2009 suggesting that two-thirds of the target set for 2005-09 has been met. Under Indira Awaas Yojana, which is one of the most successful component of Bharat Nirman 21 lakh houses. Total target was construct 60 lakh houses in rural areas between 2005-09.

Under NREGS there has been a 88% increase in the allocation in the interim budget 2009-10 against 2008-09 benefiting 44.7 million households. Besides rural sanitation coverage, part of the flagship programme Total Sanitation Campaign, has been that of 63%.

The survey however admits that there is a need for better governance and improved delivery system in order to benefit the targeted groups.

It also talks about involving the local communities such as Panchayati Raj Institutions so that local people can participate in planning and welfare. This will help prevent leakages and wastages.

S.L. Rao, chairman, Institute for Social and Economic Change says not only the amount spent on the social sector is inadequate but also the competence with which it is spent.

"I feel that at least 8-9% of GDP should be spent on the social sector besides the institutional structure should be improved. There are schools but not teachers, primary health care system is there but no doctors. I feel the panchayats (local government at village level) should be empowered and that these schemes should be audited. The problem is that local legislature does not want to give up his power therefore not enabling the panchayats to participate in these programmes, which has given rise to corruption," he said.

LOOKING AHEAD

ARVIND VIRMANI/

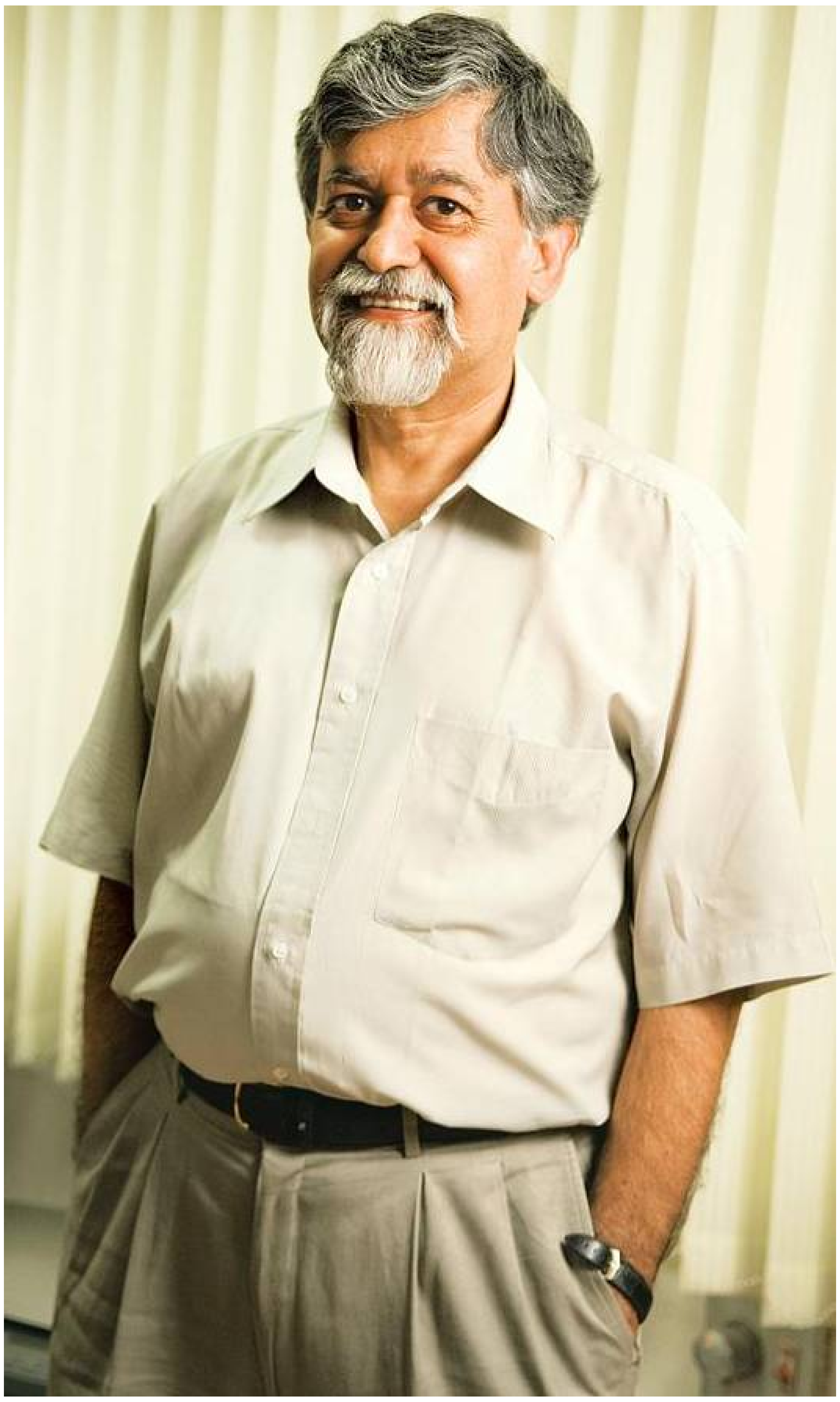
# Nothing to despair, but don’t be complacent

BY ANIL PADMANABHAN & SANJIV SHANKARAN

NEW DELHI

**What is the central message that the Survey carries?**

There is a discussion of monetary and fiscal policies and how one could look at it and some of that is in these elements where we talk about separating the temporary from the long term elements. The more important is actually a message which one has been trying to give out is that you cannot take growth for granted...... There is nothing to despair and there is nothing to rest on your laurels. There will be things that you are going to have to do. That is the message I am trying to send out. ....So that’s the big message. If you want to go back to the high growth part and to maintain it, then there is an agenda of reforms for the next four five years which must be followed. And if none of this is followed, I would be very surprised if growth is 9% five years from now.



**So it would be fair to surmise that you are cautious, but optimistic?**

Yes. I am not very good with words, but it’s been well summarized in this chapter here...’A balanced perspecitve suggests that neither should one rest on the past laurels nor should the present setback weaken the determination to return the economy to the high growth path at the earliest. High growth is critical to ensure the revenues, needed for meeting our social welfare objectives.’ So that’s another subtle social welfare message there. All these social welfare messages are very good, but if you dont have the growth and you don’t have the revenues (to sustain them).

**It also says that there is a possibility of acceleration in growth from the second half of this fiscal...**

That’s right. That is basically since the end of the last fiscal year what one has been seeing and in some sense one is surer of it that’s why we actually for the first time put in a forecast. Again. that’s the first. We’ve never had a forecast in the economic survey. And that’s why I point out it is in chapter 2. It is connected with the analysis...it is conditional on the US economy bottoming out by September..so our growth will begin to accelerate in the last two quarters. And on average we expect to come out at around 7%. This what we’ve been saying since the end of the year. Now one is slightly more confident, but again i want to point out a thing which is very deliberate, though it may appear a minor thing. And normally we set +/- 0.5 but this time we’ve set it at +/- 0.75. Because of the much greater uncertainty in the global situation. Even though a lot more people believe that the US economy will bottom out by September, yet the uncertaint is still very large. So that is why the +/- 0.75. And we added assuming a normal monsoon, because this went to press before the new forecast, which already seems to be changing.

**The overall growth scenario..you’re a little skeptical about green shoots and so on. Questions are being asked on whether asset price has more to do with monetary loosening the world over.**

The asset price we are really talking about the oil price rise..actually commodity price rise..that’s the real concern than the asset price. And that is this issue of ..remember the oil price went down to $ 40 and now it’s come to $70 plus. So i would read it more in the context of oil price, because that is what concerns us from the negative shock side.

**Is it one of the factors that has made you increase the range for growth forecast.**

No the range is because of the real economy. Remember, in all these discussions they haven’t disappeared..The L,W and V shape. There are still very many people who say it could be L or W. I would say perhaps a majority have shifted to the view that it would bottom out and not go back again. And there are others who think there could be a double dip. So the basic uncertainty is coming from the global side. That’s the issue.

**Another issue that you’ve brought up is the nature of the financial markets and how it’s all fragmented and a lot of work needs to be done. There is a strong emphasis on financial sector reforms in that chapter too.**

That is an analysis of the transmission mechanism and the issue of non-integration of market. That obviously is a medium-term concern and therefore linked to various reforms of the financial markets. And remember to the extent that capital flows remain limited. Some of those concerns have eased a little bit, right, with some resumption of capital flows in the last couple of months. But your direct question on green shoots, what i am trying to say is and that’s why i keep referring to what i have been saying earlier. There is nothing which is more than what i had said. It doesn’t make revise my estimate upwards. Remember what my estimate was..it is the U shape for the Indian economy. I mean there is nothing in this green shoots talks or example which tells me that it will be like this.

**Have the developments of the last eight weeks, especially in oil prices, made us a little more vulnerable to volatility in terms of growth?**

Well oil price remains a concern. Though some of this which comes from my people--talk about speculation and other things--as far as the impact of all of this doesn’t make much of a difference. Only thing it can determine is the balance of whether it can be temporary or permanent, an issue that i have discussed in detail. The impact of that and the policies that should follow. The fact that it happens will obviously affect us negatively. It’s a secondary level of detail whether it’s happening because global demand has gone up or speculation in US market or less liquidity.

**So as the survey points out, global growth and monsoon are the only inponderables that could take away growth in the second half?**

That’s right. However it doesn’t mean that there will be negative fall in the U curve. If things don’t go well it will only mean that it will get more stretched out.

**And now that you have the full year’s National Accounts data, that you didn’t have last year, it’s a fair statement ot make that the worst in the economy is over for now?**

That’s implied in the U-shape, isn’t it? Because Q3 Q4 is over and Q1 is halfway through. It’s over actually, but we don’t have the data.

**You’ve said earlier that the welfare initiatives are presaged on your growth and tax revenues. There’s an interesting linkage. Initially growth was assumed not to inclusive and the argument was that you are pushing growth and affecting only a part of the population. But now it says that welfare schemes need growth.**

That’s an interesting point. This allows me to point out to a small discussion here on hunger, malnutrition and poverty towards the end. Some of these indices are good for comparison, but they confuse issues when it comes to policy. These graphs show hunger right down, poverty in the middle and malnutrition right up there. To reduce it to one index is totally confusing things. But on the other hand it’s a very important issue. Even though the hunger line is down here and there are 20m people hungry, we should do something about that. Similarly there’s a huge number of kids who are mal-nourished and there’s a problem there. But it doesn’t get solved by saying we need more PDS or food. it doesn’t serve any purpose. So the message isn’t that social things aren’t important. That’s not the message at all. In some ways, the Economic Survey is the only place we talk about growth. Every ministry talks about social, Planning (Commission) talks about social. So we don’t have the space in chapter 2 to talk about it. It doesn’t mean it’s not important.

The second point is about getting complacent. People forget how much revenue growth has depended on this huge shift in economic growth. The high growth has meant high corporate investment, huge increase in corporate profits and tax revenue. It’s very easy to get used to ‘Oh we will always have this growth and we will go on increasing social spending permanently.’ That’s not true. When it falls back to 6% that will not be true.

**So to take that logic further, pursuing high growth is no longer an option, it’s a necessity?**

Yes, even for social purposes. I don’t know if want to use the word ‘necessary,’ we have used the word ‘critical.’ But necessity, yes, that word can also be used. You don’t need growth to maintain a level, you need growth to grow those levels to expand the agenda.

**Even the President’s speech referred to this..**

I think that view is understood within government. It’s not something that i have invented. But what we did want to do is emphasise it, at this point.

**So what i am trying to drive at is, you are effecting a change in the mindset...**

V: It’s not a change. The problem is people get used to a certain level. This where they have been for the last five years and they get used to a certain thing. Those who have seen just the last five years..that’s not the normal. That’s not the normal globally. Countries fall of. there’s nothing to be despaired of, but don’t be complacent.

(Jacob Koshy also contributed to the story)

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