Country focus

India needs deeper reforms to unlock full growth potential

India has emerged as one of the leading economic forces in the world. How can the country sustain high growth rates, while facing large fiscal deficits and debt, rural poverty, and underdeveloped infrastructure? Wanda Tseng, mission chief for India and Deputy Director, and Jerald Schiff, Division Chief for India, both of the IMF's Asia and Pacific Department, spoke with Conny Lotze of the IMF Survey.

IMF SURVEY: The fast pace of growth in recent years seems to have been mainly cyclical. How can India sustain higher growth?

TSENG: India is one of the fastest growing economies in the world and is certainly looking to continue growing strongly. This momentum is underpinned by dynamism in industry and services, and the emergence of a new investment cycle supported by strong credit growth. Now is really a golden opportunity for India to implement reforms and realize the economy's tremendous potential—growth rates of 8 percent or more. The key reforms include fiscal consolidation to make room for much needed investment in infrastructure and social sectors, greater openness and integration with the global economy, improvements in the business climate, and agricultural and labor market reforms.

IMF SURVEY: Are there risks to India's growth prospects?

TSENG: On the domestic front, there is the risk of not accomplishing the needed policy reforms—notably the failure to bring the fiscal deficit under control—which could push up interest rates and hold back investment. Externally, higher oil prices pose a risk, as India is heavily dependent on imported oil.

IMF SURVEY: Is India's fiscal position sustainable?

TSENG: No, but it is no secret that a public sector deficit at 9 or 10 percent of GDP and debt levels of 80 to 85 percent of GDP are not sustainable. There is recognition of this problem, as the recently adopted fiscal responsibility law demonstrated. Although the deficits have been financed with apparent ease, they have held back growth. For example, the fiscal situation has constrained infrastructure investment, which is only half of the Asian average, crowded out private investment, left little room for dealing with exogenous shocks, and made reforms in other areas, such as the financial sector, difficult.

IMF SURVEY: But how can the government plan to spend as much as an additional 10 percent of GDP on its social agenda, as laid out in its Common Minimum Program, while staying committed to fiscal consolidation?

India will benefit from pro-growth fiscal consolidation

Despite high world oil prices and a disappointing monsoon, India's economy is expected to grow at a robust pace after expanding in 2003/04 at its fastest rate in more than a decade, the IMF said in its annual economic assessment, which the authorities have agreed, for the first time, to publish. The IMF's Executive Board praised India's economic resilience but cautioned that large fiscal deficits and public debt remain a key constraint on sustained rapid growth.

The Board welcomed the new government's ambitious reform agenda focusing on creating jobs, reducing rural poverty, and addressing fiscal imbalances. It welcomed the new fiscal responsibility law, in particular the intention to eliminate the current deficit by 2008/09 through front-loaded tax reform and better quality in spending; and it encouraged the authorities to strengthen state finances.

The Board noted that tax revenues needed to be enhanced and lower-priority spending reduced to address India's infrastructure needs, and expressed concern about the proposal to spend foreign exchange reserves on infrastructure. It urged the authorities to attract private sector participation and create jobs by enhancing the investment and business climate, improving the regulatory framework for public-private partnerships, reducing overregulation, and liberalizing rigid labor laws. Further, the Board said agricultural reform is critical to growth and poverty reduction.

India's balance of payments position remains comfortable, which the Board saw as an excellent opportunity to accelerate trade liberalization. Monetary policy was aimed at curbing inflation pressures while ensuring sufficient liquidity. Exchange rate policy has become increasingly flexible. The Board also encouraged the authorities to step up efforts in building a strong and globally competitive financial sector and thus improve resource allocation.

India	2001/02	2002/03	2003/04	2004/05[1]
		(percent)		
Change in real GDP at factor cost	5.8	4.0	8.5	6.6
		(percent of GDP)		
Current account balance	0.7	1.2	1.7	–0.2
Central government balance	–6.3	–6.0	–5.1	–5.0
General government balance	–10.1	–9.6	–9.7	–9.3

Note: Data are for April–March fiscal years.
[1]Staff estimates for 2004/05.
Data: IMF staff report.

©International Monetary Fund. Not for Redistribution

Tseng: The authorities are aware that the goals of its agenda can only be achieved over the long term and would require massive investments, both public and private. So, they need to create fiscal space, especially by raising revenue and reducing inefficient spending such as subsidies. They also need to involve the private sector in infrastructure financing and attract more foreign direct investment [FDI].

IMF Survey: The fiscal responsibility law does not cover state finances. How can fiscal discipline be achieved at both central and state levels?

Schiff: The fiscal responsibility law is a good step, but it is not perfect. There are a number of states that have enacted their own fiscal responsibility legislation, but more needs to be done. States still account for about half of the general government deficit. Also, the government plans large increases over time in infrastructure and social spending, which are the purview of the states. So the pressure on states to improve their fiscal positions will only intensify. A critical step will be to implement the value-added tax in the states on April 1 as planned. Other important areas for reform include the power sector, where subsidies are sizable and inefficient, and state pension schemes, which are a rising burden on states.

IMF Survey: Why the opposition to the proposal for using the Reserve Bank of India's foreign exchange reserves to finance infrastructure?

Tseng: The infrastructure gap needs to be closed. But we wonder whether this is the best way to do so. First, this approach would require raising the fiscal deficit ceiling, which could undermine the credibility of the fiscal responsibility law in its very first year of existence. Second, it could compromise perceptions about central bank independence and reverse the good progress made in recent years in lowering inflation expectations and interest rates. Third, experience has shown that once business constraints are removed, properly packaged infrastructure projects could attract private investment.

IMF Survey: What are the reasons for India's services sector boom?

Schiff: There are a number of factors behind the boom in India's services sector. Technological advances, which have allowed services to be delivered at great distances, have, of course, encouraged outsourcing. This is an area where India is a world leader. Domestic demand for services is also rising as incomes grow. However, policies have also played a key role. The services sector has been less heavily regulated and taxed than other sectors. We found that particular services grew much faster once they were open to FDI, trade, or private ownership. This can serve as a model for other parts of the Indian economy.

Henrik Gschwindt De Gyor/IMF

Tseng (with Schiff): "A public sector deficit at 9 or 10 percent of GDP and debt levels of 80 to 85 percent of GDP are not sustainable."

IMF Survey: How can India create the 110 million new jobs it will need over the next 10 years, given its demographics?

Schiff: The growth of the service sector will have only a modest impact on employment. Even the most optimistic assumptions point to the IT sector employing some 2 million people by 2008, less than 1 percent of the labor force. The type of job creation India needs will have to happen primarily in labor-intensive manufacturing. Hence, India needs to pursue the reform agenda. Labor market reforms, in particular, are needed for India to reap the benefits of trade openness.

Tseng: And a major shift in jobs away from agriculture is rather unrealistic. About 60 percent of the population work in agriculture, producing ¼ of GDP. So there is room to increase productivity. It makes perfect sense that the government is focusing on enhancing rural infrastructure. Incentives for farmers to diversify and export more also need to be improved.

IMF Survey: Why is FDI in India so much lower than in other emerging markets, for example, China?

Schiff: The government has made attracting FDI a priority and has removed several restrictions recently. India's FDI regime is no longer particularly restrictive by international standards. The problems lie much more with the overall quality of the business climate, for example, cumbersome regulation. But in many areas, improvements have been made, and a number of investor surveys indicate that India will be one of the top two or three destinations for FDI in coming years. So pushing ahead on reforms now would have a big payoff later. ■

For more information, refer to IMF Public Information Notice No. 05/12 on the IMF's website (*www.imf.org*).

©International Monetary Fund. Not for Redistribution