CHAPTER 3

INDIA'S ECONOMIC SIGNIFICANCE

Today India is one of the most exciting emerging markets in the world. Skilled managerial and technical manpower that match the best available in the world and a middle class whose size exceeds the population of the USA or the European Union, provide India with a distinct cutting edge in global competition.[1]

Advantage India

3.1 The growth in the Indian economy with reforms spreading and being based on a national consensus has produced significant advantages that India can offer on top of the geographical and political advantages.

3.2 The Joint Indian Business Councils, the Federation of Indian Chambers of Commerce and Industry (FICCI) and the Associated Chambers of Commerce & Industry of India (ASSOCHAM) point to some of the major advantages that India offers, including:

- geographically strategically located;
- largest democracy with stable political system;
- private sector is the backbone of the economy, accounting for 75 percent of GDP;
- measured in terms of the dollar at purchasing power parity, India's GDP is the fifth largest after USA, China, Japan and Germany;
- rapidly growing consumer market with 250 million strong middle class;
- sound legal system;
- widespread usage of English for official and business communications;
- second largest English speaking scientific base in the world with over 200 universities and 2000 research institutes;
- a member of World Trade Organisation (WTO);
- vast reservoir of natural resources and large pool of technically skilled, relatively inexpensive manpower; and
- wage rates in India vary according to industry. Minimum wage rate for an unskilled worker is approximately US$2 per day; average wage rates for skilled labour are approximately US$100 a month.[2]

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1 *Discover India*, Official website of the Government of India: <http://www.meadev.gov.in/economy>

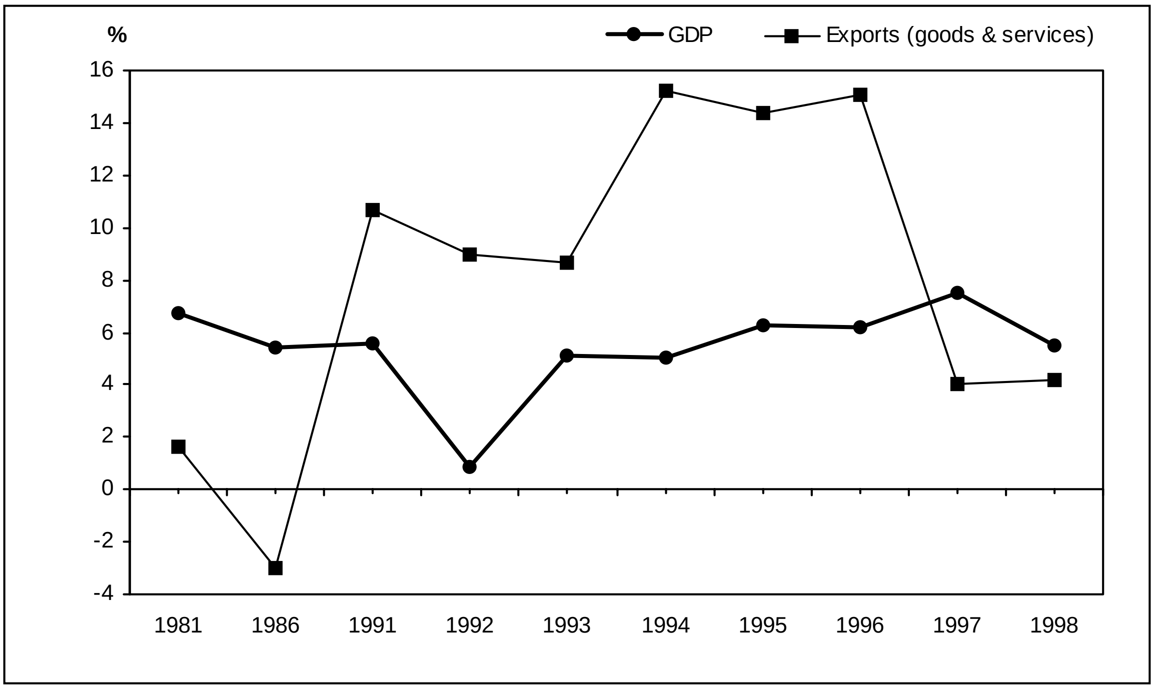
2 *Indian Economy: A New Look*, paper by the Joint Business Councils of India, 1997.

India's Economy - Post 1991

3.3 India's economy has been described as 'huge, complex and growing'.[3] According to World Bank calculations based on purchasing power parity (PPP), India was rated as the world's fifth largest economy in 1994 and it is expected to be the fourth largest economy in the world by about 2020, behind China, United States and Japan. Shand and Kalirajan note that 'these perspectives signal the huge potential of India in terms of a market for trade in goods and services and as a destination for direct foreign investment'.[4]

3.4 Since the macroeconomic crisis in 1991, India's GDP growth rate has climbed to levels exceeding those of the 1980s (averaged 5 percent) - 7.2 percent in 1994-95, 7.1 percent in 1995-96, 6.8 percent in 1996-97, with the Indian Government originally estimating real GDP growth of 7.0 percent in 1997-98.[5] This rate has been scaled down to 5 percent. Figure 3.1 shows India's growth rates of GDP and exports from 1981 to 1998.

Figure 3.1 India's Growth Rates of GDP and Exports, 1981 to 1998



Source: ASARC Exhibit No. 116.

3.5 During 1997 there was some deceleration in economic activity concentrated in industrial production and stemming from weakness in investment and exports. According to the IMF, among the factors underlying the marked weakness of India's recent export performance were sluggish partner country demand, including the Asia region, lower international diamond prices, and increased non-tariff barriers in the European Union (India's major export market) on Indian textile product. Furthermore the IMF pointed to the impact of the dwindling expansionary impulse of trade liberalisation and the exchange rate adjustments of the early 1990s. Deepening infrastructure problems, such as capacity constraints on roads and ports have also adversely affected both investment and export

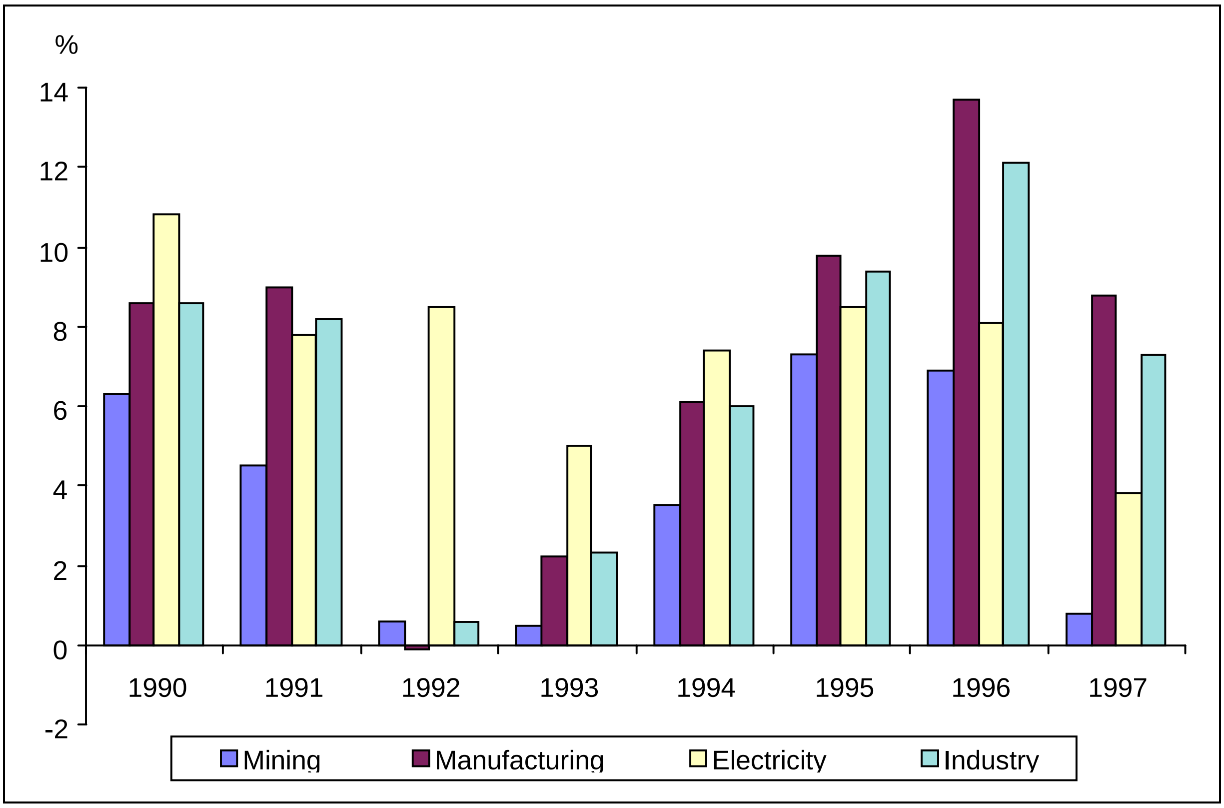
3 DFAT Submission, p. S 722.

4 Exhibit No. 74.

5 The financial year in India runs from April to March.

growth.[6] Figure 3.2 shows annual growth rates by major sectors in the Indian economy from 1990 to 1997.

Figure 3.2 Annual Growth Rates by Major Sectors, 1990 to 1997



Source: ASARC Exhibit No. 116.

Economic Reforms

3.6 Following the crisis, the Government of India (GOI) took drastic action including devaluation, the imposition of high interest rates, fiscal and monetary restraint and import compression.[7] In succeeding budgets long term measures were introduced which removed the protection of Indian industry and commerce from international competition. Of particular importance in liberalising the investment and industrial regimes were:

- the decision to eliminate discriminatory treatment of enterprises with more than 40 percent of foreign equity;

- the opening of a number of sectors to domestic and foreign private investors:

    - power (March 1992)
    - mining (March 1993)
    - coal (March 1994)
    - telecommunications (May 1994)
    - pharmaceuticals (September 1994);

6 *World Economic Outlook, October 1997*, International Monetary Fund, Washington DC, 1997, p. 46.
7 SARU Submission, p. S 481.

- the elimination of prior government approval in decisions concerning expansion, diversification, merger and acquisition;

- the reduction of entry barriers to only a selected group of sectors - defence products, atomic energy, coal and lignite, mineral oils, railway transport and radioactive materials;

- introduction of the convertibility of the rupee in 1994;

- the replacement of fiscal incentives and concessions with straightforward cuts in tax rates:

    - reduction in corporate tax rate for foreign companies from 65 percent to 45 percent in 1997 (the comparable figure for domestic companies was lowered to 35 percent); and

    - reduction in long-term capital gains tax from 30 percent to 10 percent in 1997.[8]

3.7 Box 3.1 sets out the major elements in India's economic reforms from 1991 to 1997. Of significant interest is the encouragement of overseas investment by legislation - at both the central and state levels - which has targeted non-resident Indians (NRIs), multinational corporations and foreign direct investors (FDIs) by removing ceilings on foreign investments and easing restrictions on the repatriation of profits.[9] The political uncertainty throughout 1997, which led to the resignation of Prime Minister Gujral in November 1997 and the President ordering fresh elections be held in February 1998, had an impact on the passage of reform legislation through the Indian Parliament. In October 1997 the IMF commented on the slowing of investment growth in India over the year, noting that it was partly due to political uncertainties as well as the public sector's continuing absorption of a significant portion of financial savings to finance its deficit, and the consequent high real interest rates.[10]

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8 *South Asia's Integration into the World Economy*, World Bank, Washington DC, 1997, p. 92.
9 SARU Submission, p. S 482.
10 IMF, op. cit.

Box 3.1 Major Elements in India's Economic Reforms 1991-97

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3.8 **Common Minimum Program (CMP)**. The year 1996 marked a watershed in terms of reform. With the 1996 elections there was concern about the level of commitment to reform by a new government. Following its formation and appointment, the United Front Government, a Centre-Left Coalition with a strong regional emphasis, issued a key pro-reform policy document, *A Common Approach to Major Policy Matters and Minimum Program (CMP)* which reflected the broad areas of agreement amongst its constituent parties. In an economic program committed to growth with social justice, the priorities included a target growth rate for GDP of 7 percent annually over 10 years aimed at abolishing poverty and unemployment; reduction of the fiscal deficit to below 4 percent of GDP; increased investment in infrastructure to at least 6 percent of GDP; further reforms in the financial sector aimed at enhancing the flow of domestic and foreign funds; a clear acknowledgment of the pivotal role of FDI with an annual target of US$10 billion; agriculture and tax reforms, and concentration of public sector investment in health and education.

3.9 As Shand and Kalirajan point, out the implementation of the CMP gave commitment to the reform program of the previous Congress Government, as well as broadening and deepening reform. Additionally:

> ... it commits the Government to devolution of administrative and economic powers and decentralisation of authority to the States in a new emphasis on federalism. The CMP has been welcomed amongst UF's outside supporters. The Congress Party and the Communist Party (Marxist) have given it unconditional support. Furthermore, the clear acknowledgment of the crucial role of foreign investment and the need to ensure its security has assured foreign investors waiting for economic policy signals from the electoral process.[11]

3.10 **National Agenda for Governance.** Although the 1996 CMP provided Central Government commitment to the continuation of the economic reform process and responsible economic management, the 1998 election outcome, with India's Hindu nationalist party, the BJP being asked to form a government, provided greater international focus on the level and pace of economic reform in India. The question being asked was what was the position of the new Government. The BJP's leader Atal Bihari Vajpayee was sworn in as India's 13th Prime Minister on 19 March 1998, and although regarded as a moderate, his party during the campaign preached the theme of *swadeshi* - economic nationalism - with the focus on protection to domestic industry, with Indian industry being given protection for a period of seven to ten years to prepare for global integration.

3.11 On 18 March 1998 the BJP Government and its allies brought down their 'common minimum program', the *National Agenda for Governance*. The Government committed itself to continuing with the reform process and aims to give it a strong s*wadeshi* thrust 'to ensure that the national economy grows on the principle that "India shall be built by Indians".' Highlights of the Agenda include:

- GDP growth of 7-8 percent and controlling fiscal deficit;
- increasing national savings to 30 percent of GDP;

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11 Exhibit No. 74.

- giving a major thrust to infrastructure development particularly in the areas of energy and power by recommencing public expenditure in the sector, accessing long-term funds in the national and international markets, removing administrative bottlenecks;

- encouraging FDI in core areas and discouraging FDI in non-priority areas (eg the consumer market);

- earmarking 60 percent of the Plan Funds for and effect public investment in agriculture, rural development, irrigation;

- instituting a comprehensive study of the financial, technological and social security requirements of the self-employed and unincorporated sector;

- undertaking a review of all laws and regulations relating to industry to free it from bureaucratic control, instituting a system of voluntary compliance with laws including tax laws, ensuring speedy redressal on industrial sickness [sic], reviving the capital market as a viable and transparent mechanism for raising capital, expediting comprehensive reform of Public Sector Units (PSUs) including restructuring, rehabilitation and divestment;

- calibrating the process of globalisation by devising a timetable to suit national conditions and requirements;

- enacting the Broadcasting Bill[12] to regulate private broadcasting and to protect Indian interests, restricting foreign equity holding in private television broadcasting to 20 percent and preventing cross holding to avoid emergence of monopolies in the media; and

- establishing an appropriate legal framework for the protection of the environment and unveiling a National Environment Policy to balance development and ecology.[13]

3.12 The BJP Government has been described as 'the most diverse and defection-prone coalition ever seen in India'.[14] With some sixteen partners in coalition with the BJP, the Government will be hard pressed to keep the various interests happy. The rise of regional parties and the political uncertainty created by the ever-present threat of the coalition falling apart will no doubt impact on the passage of reform legislation through the Parliament and temper opposition to foreign investment within the Government by the more extreme Hindu nationalists.

3.13 DFAT is heartened by the record of BJP State Governments which have shown no sign of discouraging foreign investment and:

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12 Australia Television (AusTV) submitted a submission and the Chief Executive of AusTV gave oral evidence last year to the Lok Sabha committee of the Indian Parliament examining the Broadcasting Bill before the Parliament at the time.

13 Excerpts from the *National Agenda for Governance - BJP and Allies*, New Delhi, 18 March 1998.

14 *The Australian*, 'Hindu ascension shuns Gandhi's coup' by John Zubrzycki, 16 March 1998.

> ... it is also important to be aware of the in-built drivers of economic reform in India: the growing momentum for further reform as benefits become more evident; the undeniable need for massive inflows of foreign investment (with an estimated US$150 billion required for India's infrastructure development alone); India's growing integration with the world economy and consequent need to be more competitive; the unsustainable drain of inefficient public sector operations and extensive subsidies; and the cash-strapped State Governments competing for investment dollars.[15]

India's Budget 1997-98 and Interim Budget 1998-99

3.14 In both 1997 and 1998 the Indian Budget was delayed as a result of political instability and the collapse of the government of the day. This time last year there was a political shakedown with the resignation of Prime Minister Gowda before the Budget was passed. The United Front Government was reformed under the Prime Ministership of Inder Kumar Gujral. As DFAT notes:

> One of the first things Prime Minister Gujral did upon taking office was to re-assure the business community, both domestic and international, that there would be no turning back from the economic reform process and that India could look forward to "its deepening and widening". He also worked hard, and in the event successfully, to secure the agreement from Gowda's highly-respected Finance Minister, Chidambaram,[16] to resume that position in the Gujral Ministry. The Budget was passed in May [1997] without any major changes.[17]

3.15 The highlights of the 1997-98 Budget are set out in Box 3.2 below.

15 DFAT Submission, p. S 994.
16 A strong advocate of economic liberalisation and responsible for the implementation of the CMP.
17 DFAT Submission, p. S 741.

Box 3.2 India's Budget 1997-98: Highlights

The 1997-98 Budget was well received for continuing India's economic reforms. It broadened the tax base, rationalised excise, reduced tariffs and broadly aimed to encourage increased investment. Capital market regulatory reforms, minor liberalisation of the insurance sector, and fillips to the power sector, telecommunications, irrigation and transport infrastructure were provided for. It was anticipated that outlays would increase slightly, but the deficit was expected to fall to 4.5% of GDP because of increased revenues and fiscal discipline, and provided a forecast growth of 7% and inflation of 6-7% for the year.

TAX

- Various changes to taxes affecting business, inter alia, 7% reduction of corporate tax rate for foreign companies to 48%; 5% reduction for Indian companies to 35%; and abolition of the 7.5% surcharge;
- Rationalisation of excise duties towards an average of 18%, including reductions for mass consumption items, consumer durables, and exemptions to dairy machinery;
- Service taxes broadened;
- Personal income tax reduced by 5-10%.

TARIFFS

- Tariff peaks reduced from 50% to 40% and continued reductions to ASEAN[18] levels foreshadowed over next three years;
- Reductions ranging up to 25%, including for: automotive CNG kits and catalytic converters; capital goods; chemicals; coal; dyes, pigments, paint and varnishes; information technology equipment; iron and steel products; ophthalmic blanks; photographic films and cine stock; specialty foods; telecommunications equipment and parts; wool and wool tops.

INVESTMENT INCENTIVES

- Equity limits for foreign institutional investors increased by 6% to 30%;
- 5 year tax holiday, and other tax concessions, on investment in telecommunications;
- Special tax deductions to development of tourist hotels;
- Incentives to oil and gas exploration and production;
- 10% levy on distributed profits, incident on companies.

Source: DFAT Submission, p. S 743.

3.16 With the BJP forming a government and the swearing in of Shri Atal Bihari Vajpayee, the leader of the BJP, as Prime Minister on 19 March 1998, the Government brought down an interim Budget for 1998-99 on 25 March 1998 to enable it to carry on its business and meet essential expenditure during the first four months of the next financial year.

3.17 In his Budget Speech the new Minister of Finance, Shri Yashwant Sinha, noted that the Government is concerned that overall economic growth has slowed to 5 percent in 1997-98, agriculture has registered negative growth of 2 percent, industry continues to be in the doldrums averaging only 4.6 percent growth over the 12 months to January 1998, and exports have recorded negative growth in dollar terms in each of the three most recent months up to January 1998 for which data are available. He added that the bottlenecks in the key

18 Under a 1995 agreement by ASEAN Heads of Government, around 87 percent of tariffs are expected to reach 0-5 percent by 2000 and 41 percent of all tariffs are expected to reach 0 percent by 2003. Average tariff rates in the ASEAN Free Trade Area (AFTA) countries were 6.38 percent in 1997.

infrastructure sectors are well known, the capital market has been lacklustre and the fiscal situation is significantly worse than expected.

3.18 There are a number of significant aspects to the interim Budget, with the most important being the commitment to deepening, broadening and accelerating economic reforms. The political uncertainty over the last year has slowed the pace of economic reform. Observers believe that part of the slump in the Indian economy has resulted from this uncertainty. There was much speculation in the lead up to this last election that a BJP-led Government, given its election manifesto, may become inward looking and slow the pace of reform.

3.19 The Government has set a GDP growth rate of 7-8 percent and will accelerate development of infrastructure, particularly in energy and power production. A major area of focus will be the restructuring of centre-state relations, with the aim to decentralise financial and administrative powers to the states. This is of particular significance since the states are undertaking major reforms and have been competing with each other to attract foreign investment to advance their economic development.

3.20 The highlights of the interim Budget are outlined in Box 3.3 below.

Box 3.3 Interim Budget 1998-99: Highlights

- Rs.7594 crore to be devolved to states under VDIS* in 1997-98.
- Rs.1000 crore more to be given as additional central assistance to states in current financial year.
- Constitutional amendment bill to be introduced soon to give effect to alternative scheme for sharing of resources between centre and states.
- Interim budget seeks to continue existing tax structure.
- Fiscal deficit pegged at 6.1 percent for current financial year.
- Net tax revenue for centre shows a shortfall of 12.6 percent.
- Large shortfall in disinvestment receipts.
- Growth in establishment expenditure to be contained process of PSU** disinvestment being accelerated and made transparent.
- Economic reforms to be deepened, broadened and accelerated.
- Budgetary support plan at Rs.64461 crore level content and level of budgetary support for the annual plan 1998-99 to be reviewed in the regular budget.
- Regular budget will seek to impart necessary stimulus to agricultural and industry, restore dynamism to exports and encourage larger flows of foreign investment.
- Regular budget to strengthen financial system, improve infrastructure and bring strict fiscal discipline.

*Voluntary Disclosure of Income Scheme **Public Sector Unit

Source: Ministry of Finance, Government of India <http://www.nic.in/indiabudget/ibudget98-99/high.htm>

Export and Import Policy (EXIM)

3.21 The Exim policy is the policy umbrella under which the Ministry of Commerce and line Ministries administer a plethora of import licenses, a duty drawback program, national and international standards, tariffs, taxation concessions, subsidies, incentives and controls.[19] As DFAT states:

19 DFAT Submission, p. S 736.

> ... the EXIM policy is a manifestation of official intervention, and an example of the complex and labrynthian [sic] nature of the Indian bureaucracy. As the source document, or "blueprint" of general measures affecting merchandise trade, it provides the broad parameters under which trade may be conducted.[20]

3.22 Under India's 1992 five year Exim policy, a framework for globalisation of India's foreign trade was set with the focus on:

- improving the productivity and competitiveness of Indian industry;
- raising the quality of Indian goods;
- facilitating the import of materials for value added manufacturing and re-export;
- minimising licensing and other discretionary controls;
- fostering research and development; and
- streamlining procedures governing exports and imports.[21]

3.23 India, as DFAT points out, has, through its export-import policies, made strides in lowering tariffs and removing other barriers to trade. The 1997-2002 Exim policy renewed and extended these initiatives with new incentives announced for exports in agriculture, high technology, capital goods, export processing zones and jewellery sectors. The policy also covered further liberalisation by removing items from the restricted list. However there was concern that the policy failed 'to take due account of [the] likely progress on removing restrictions. There have also been charges that the policy has not set any new direction, and that the changes were piecemeal'.[22] Australia's approach last year through the World Trade Organisation (WTO) brought about a better outcome for Australia on the phase-out of quantitative import restrictions.

3.24 On 13 April 1998 the BJP Government released modifications and amendments to the 1997-2002 Exim policy. In announcing modifications to the policy (see Box 3.4), against the backdrop of India's poor export performance over the last year, Commerce Minister Hegde said he 'had tried to focus mainly on improvement of export competitiveness' and was convinced 'that the cumbersome export procedures have to be radically changed to minimise the transaction costs and delays'.[23] The revised policy comprises a series of interventionist measures affecting both exports and imports. The Exim policy is where modifications to the list of import restrictions are made and in this policy revision some 340 items were moved from the restricted list onto the free list - the OGL (open general license). Minister Hegde has set an export growth rate of 20 percent for 1998-98. In examining the growth projections set by the new Indian Government, the Asian Development Bank (ADB) believes that the 8 percent economic growth and 20 percent export growth projections are 'slightly over ambitious'.[24]

BOX 3.4 Exim Policy 1997-2002: Highlights

20 ibid.
21 ibid.
22 ibid. p. S 737.
23 Excerpt from speech delivered by the Hon Commerce Minister Shri R K Hegde on 13 April 1998 on the occasion of the release of the revised Exim policy, GOI, Ministry of Commerce, New Delhi.
24 *AAP*, 'Growth projections "slightly over ambitious" ', New Delhi, 30 April 1998.

IMPORTS

- 340 items shifted from restricted list to open general list. Some items are also proposed to be shifted from the restricted to the special import license list.
- Quick clearance of goods at sea ports and airports in a time bound manner to be facilitated.
- For the garment sector, trimmings and embellishments permitted for import as a part of personal baggage on payment of applicable duty.
- Export Promotion Capital Goods (EPCG) licenses will henceforth carry automatic validity for any variation up to 10% in the value, for which the license has been issued.
- Threshold limit under EPCG zero duty scheme reduced to Rs.1 crore from Rs.20 crores for garments, electronics, agro and food processing sectors, sports goods, toys, leather, gems and jewellery.
- EPCG threshold limit for software reduced to Rs.10 lakhs under zero duty scheme.
- EPCG license holders have been allowed to export further value added products with an enhanced export obligation.
- Jigs, fixtures, moulds and dies have been permitted to be imported against EPCG licenses.

DUTY EXEMPTION SCHEME

- Issue of licenses decentralised.
- Duty Entitlement Pass Book scheme (DEPB) to continue.
- 5% special customs duty under DEPB to be neutralised.
- DEPB rates of over 300 new export items have also been finalised - to be announced.
- More time granted for filing post-export DEPB claims.
- To mitigate the difficulties of Small-Scale Industries (SSI) Units, private bonded warehouses being set up to import, stock and sell even negative list items to holders of advance license.
- Advance licenses to be issued to all status holders automatically on the basis of information furnished by them.
- One time extension in export obligation period will be given in respect of quantity based advance licenses on payment of prescribed extension charges.
- Licenses permissible on production programme basis will henceforth carry flexibility allowing change in the description of export product. Additional licenses will be given without delay during the same year on completion of export obligation.
- Procedures simplified, eg clubbing of advance licenses will now be allowed.
- Under Advance License facility, entitlement for import of trimmings and embellishments has been enhanced from 2% to 5%.

DIAMOND, GEMS & JEWELLERY EXPORT PROMOTION SCHEME

- Exporters of gold jewellery will be given the benefit of duty drawback in respect of gold taken on payment of duty from the nominated agencies.
- Wastage norms and value addition norms brought at par with international standards to benefit exporters.
- Replenishment licensing scheme based on value of gold has been extended to silver and platinum jewellery as well.
- Export of branded jewellery for display/sale has been permitted.

EOU/EPZ/EHTP/STP[25]

- For agriculture and allied sector Export Oriented Units (EOU)/Export Processing Zone units (EPZ), the minimum value addition norms have been modified to positive net foreign exchange basis.
- Depreciation limit for Export Oriented Unit/Export Processing Zone units being enhanced from

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25 EHTP - Electronic Hardware Technology Park: STP - Software Technology Park.

70% to 90% over a period of 5 years.

DEEMED EXPORTS

- Time limit of 6 months for filing application for refund of terminal excise duty and drawback under brand rate shall be from the date of issuance of payment certificate instead of date of payment as was envisaged earlier.

EXPORT HOUSE

- Special Import License has been allowed to ISO-9000 quality certification holders even for export of 'on-site consultancy services'.
- Special Import License entitlement for electronics sector has been enhanced from 15% to 25%.

EXPORTS

- Focus on improvement of export competitiveness.
- To facilitate bulk imports from India by large overseas buyers, private bonded warehouses being set up, for such exports. The supplies to these bonded warehouses against payment in foreign exchange through normal banking channels will be treated as 'exports'.
- Pharmaceutical companies allowed to export free samples as per international practice.
- Exports of oilseeds and oil relaxed.
- Long-term, stable agricultural export policy to be established as a reliable supplier in the international market. Therefore, items freely allowed to be imported to be free from export restrictions.
- For the development of floriculture, horticulture products, handicrafts, and tourism, the required infrastructure and other facilities to be provided for boosting exports.
- Dialogue planned with 500 corporates & Public Sector Units (PSUs) to improve their share of total turnover from 10% and 4% respectively to 20%.
- Discussions and consultations to be held periodically with exporters and trade bodies.

SIMPLIFICATION

- Move towards a trust-based system.
- Computerisation of Directorate General of Foreign Affairs (DGFT) offices to be completed by the year end.
- The Exim Policy and the Handbook of Procedures on the Internet and henceforth all Public Notices issued by the DGFT to be accessible on Internet.

ANTI-DUMPING

- Directorate General of Anti-dumping and Allied Duties set up to counter the effect of the unfair trade practice of dumping so as to provide effective protection to the domestic industry. A facilitation cell set up to assist the industry in finalising application documentation.
- A brochure detailing the procedure for use by industry for anti-dumping releases.

Source: Confederation of Indian Industry <http://www.indianindustry.com/ew/ewpu/exim97.htm>

3.25 With the policy announcements by the new Government since it was elected, concerns over the likely thrust of *swadeshi* and its impact on trade and investment in India have been allayed.

> Based on the new Government's interim Budget, its export/import policy and comments in Parliament, Canberra believes that concerns about "swadeshi" - or autarky [sic] - are overstated.[26]

26 *The Australian Financial Review*, 'Australia's India trade set to double' by Nick Horden, 22 April 1998.

3.26 The policy announcements which include a GDP growth target of 7-8 percent mean the Government needs to increase the pace of economic reform. In fact the IMF in its semi-annual World Economic Outlook says that the recent slowing of growth in India, while attributable to cyclical factors, suggests that the boost given by the reforms initiated in 1991 has been wearing off. Furthermore the IMF says that 'to put India in a sustainably faster growth path, stronger efforts are needed to reduce the large fiscal deficit, liberalise foreign trade and investment, alleviate infrastructure bottlenecks, deregulate the domestic product market, and reform the financial and enterprise sectors'.[27]

The Indian Market

3.27 With the opening up of India's economy, there is considerable focus on the size of the Indian consumer market and the potential it holds for Australian business. The second most populous nation on earth, India's population is approximately 950 million and growing at an annual rate of 2 percent. Discussion of India's market potential has centred around the size and growth of the middle class.

3.28 It has been estimated that the size of the Indian middle class ranges between 220 million and 335 million people. In discussions on the size and potential of the Indian market there is a degree of hype surrounding these figures which need to be viewed in the Indian context. Australian business and government tend to use a middle class definition that equates to Australia whereas in the Indian context experts such as Professor Rao (see paragraph 3.31) prefer to use different definitions based on consumption patterns.

3.29 The National Council for Applied Economic Research in Delhi classified Indian households into five income groups:

> Excluding the highest and lowest, the number of households in the three intermediate income levels, considered to be the middle class, are estimated at 295 million people if the labor force, between the ages of 15 and 59 is taken. Alternatively, if the population in the three intermediate income classes of households, between the bottom and the top, taking account of the occupations of household heads, are taken, the middle class (present and potential) would be between 220 and 335 million people.[28]

3.30 This middle class is still predominantly rural and the proportion of the population in the lower income groups in India is higher in rural than in urban India, but the proportion in the top three income groups is growing faster in rural than in urban India.[29] With the increasing importance of the rural market, manufactured products already constitute a major part of the market. As the Western Australian Department of Commerce and Trade notes:

> Even though over half of the population falls in the lowest income category, the data shows that they purchase a variety of manufactured consumer products (usually among those of low unit value - for example, more of transistor radios and mono recorders than

27 *AAP*, sourced from Asia Pulse, Washington, 13 April 1998, 'India needs to accelerate economic reforms: IMF, 14 April 1998.
28 ASARC Submission, p. S 123.
29 WA Government Submission, p. S 817.

stereophonic hi-fi, or small black and white rather than colour television sets), and by themselves form a large market.[30]

3.31 Professor S L Rao, a Visiting Fellow at the Indian Ocean Centre in Perth, and former Director-General of the National Council of Applied Economic Research, Delhi, provides a summary of the structure of the Indian market, set out in Box 3.5 below.[31]

Box 3.5 The Structure of the Indian Market

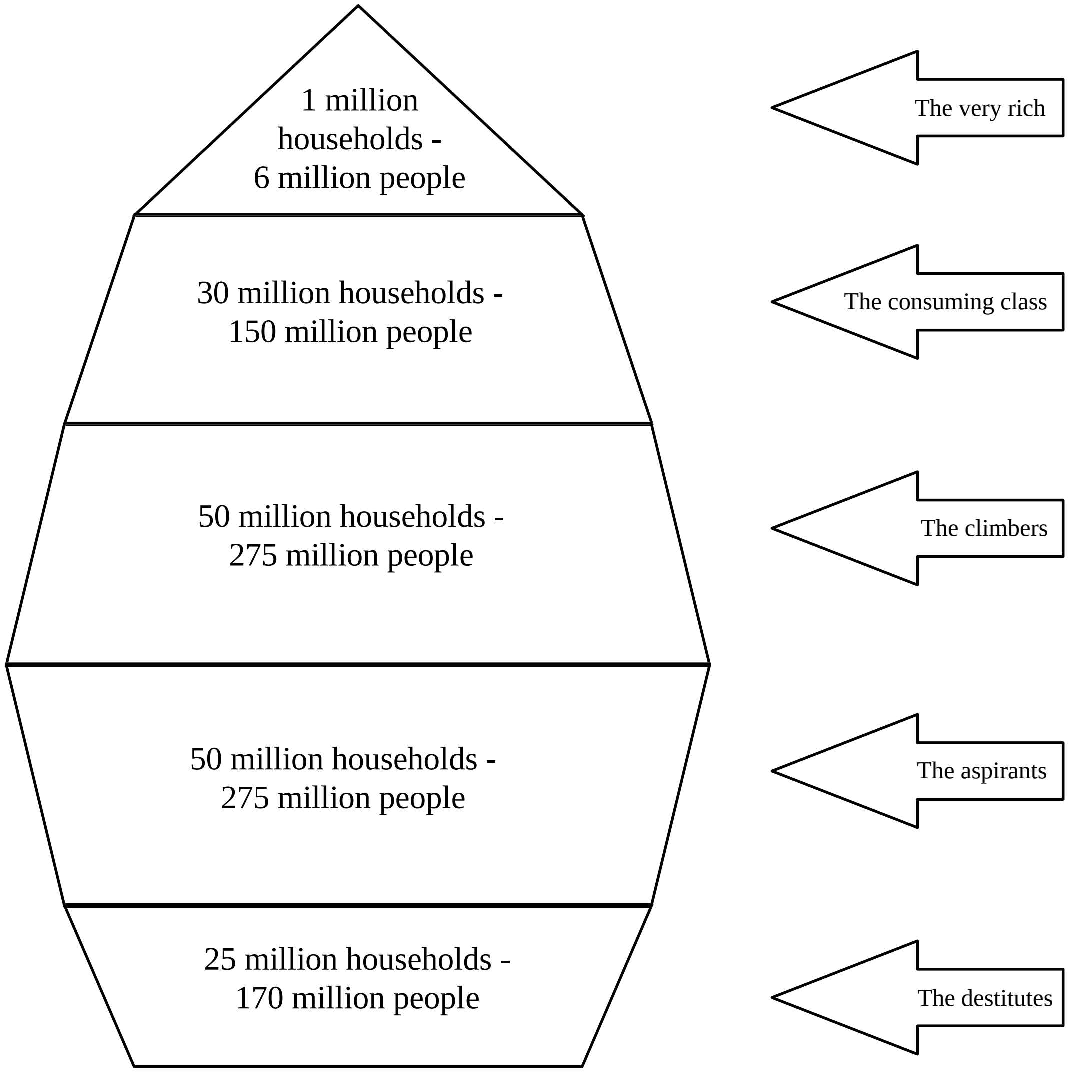
- Rural markets are already large and are growing fast;
- People are graduating from the lowest to the higher income groups;
- There is a sizeable population of those who by Indian standards could be said to be the 'very rich' (1 million households have an annual income greater than Rs. million);
- There has been a surge in the purchase of consumer products by households, and the ownership of consumer durables;
- This surge is not confined to people with high levels of income. Even those who appear to be poor, in the lowest levels of income, purchase and use such products;
- Most of the purchases are made from the income of the households. Hire purchase and loans account for around ten percent of ownership of durables, and gifts for a mean of around 5 percent, with wristwatches being the most common gift (around 10 percent);
- Second hand products bought and owned by households are primarily of bicycles - 15 percent. Others, at around 5 percent, are products like radios, cassette recorders, wristwatches and table fans, but not pressure cookers.

Source: Exhibit No. 102.

3.32 An extremely useful guide to understand the size and scope of the Indian market is provided by Professor Rao's figures on the structure of the market for 1994-1995 (see Figure 3.3) and for the years 2001-02 (see Figure 3.4).[32] He believes it is far more relevant to structure the market according to consumption rather than income patterns. He has found that similar incomes in different parts of the country do not represent similar levels of purchasing power. There are regional differences in prices and the cost of living in the cities is more expensive. The 'poorer' people in rural areas may in fact have greater purchasing power than their 'wealthier' urban cousins.[33] It is interesting to note that rural consumption is increasing but it is limited by two factors - lack of credit facilities and uncertain electricity supplies.[34]

30 ibid. p. S 816.
31 Exhibit No. 102.
32 ibid.
33 *Australia-India Focus*, 'India's "mythical" middle class', Issue 3, December 1997.
34 ibid.

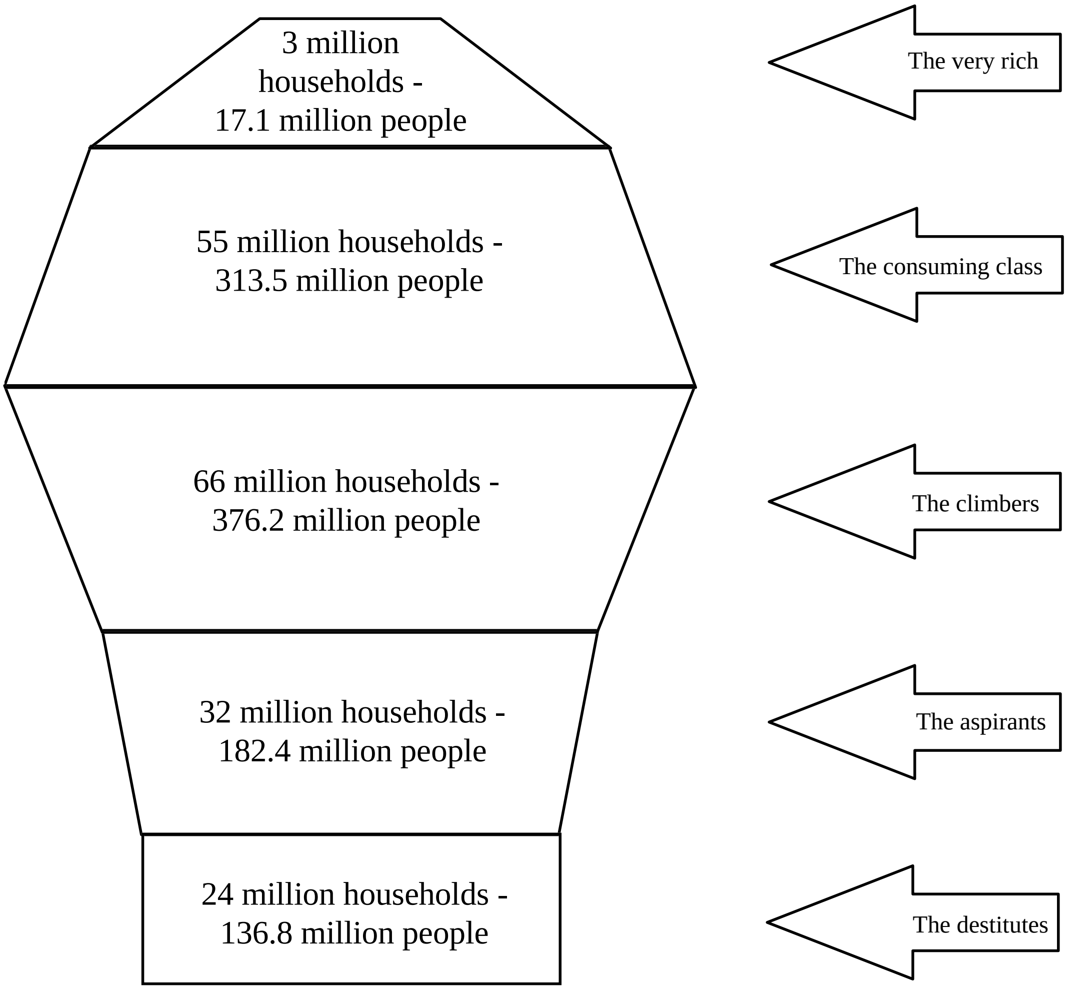
Figure 3.3 The Structure of the Market 1994-95



1. In this and the next figure, Dr Rao projects the market structure in the year 2001-02. He points out that the shape is moving towards a diamond, with an expanding number of the very rich, a fast expanding consuming class and hence a mass market, and the remaining destitute and aspirants of the bottom.

2. Dr Rao says the market for most products, except the most expensive ones, would be made up of the top two sections - *156 million people or so. The mass market would have an additional 275 million people or so.*

Figure 3.4 The Structure of the Market 2001-2002



3.33 Although the Indian market is enormous it is important to understand that it is segmented. Politically India is one nation with strong vested interests in remaining so at the bureaucratic, military and commercial levels, but to view India as a homogeneous country is simplistic. India is a diverse federation of 26 states, each with their own separate governments, and five union territories, with its people divided by language, religion, race, location and socio-economic class.[35]

3.34 The Committee was informed that India's heterogeneity is reflected in differences in consumption patterns and that the Indian market can be segmented in many different ways. Therefore the skill in developing strategies for maximising commercial opportunities in India is in understanding how these segments can be classified and divided to ensure the relevance of products and services and that market strategies confer product and brand loyalty on the supplier.[36]

3.35 **Recommendation 1**

35 WA Government Submission, p. S 817.
36 ibid.

The Committee recommends that:

The Australian Government, in advancing Australia's commercial interests in India, ensure that the heterogeneity, and regional and state differences to be found in India are reflected in trade policy development and trade promotion activities.

Impact of Asian Currency Crisis

3.36 The Indian economy has been relatively insulated from the Asian currency crisis fallout. The uncertainty surrounding the Indian political scene over the last year has had a greater impact on economic growth than the currency crisis.

3.37 India's relative insulation from the financial crisis is due in part to the limited convertibility of its currency and the low level of short term foreign investment. The dramatic depreciation of a number of East Asian currencies did push the rupee down to just over 7 percent against the US dollar (compared with its April 1997 value).[37] The Reserve Bank of India (RBI) acted to stem the slide of the rupee announcing in October 1997 and January 1998 a series of measures to support the rupee. These measures have been successful to date without India having to draw heavily on its foreign reserves.

3.38 The Asian currency crisis means that India faces stiffer competition from South East Asian economies in third markets, particularly in sectors such as food, animal products and manufactured goods, which will curtail export growth. Imports will be cheaper from these countries and will provide competition to the domestic product.[38] The Indian Government is keeping a close watch on possible dumping by countries under pressure from the crisis. India's exports of cotton yarn, garments, jewellery and soyameal have been adversely affected by the sharp depreciation in East Asian currencies.

3.39 In announcing the revised Exim policy, Commerce Minister Hegde responded to the challenge to India's export competitiveness posed by the South East Asian currency situation saying that the exchange rate for the rupee is a floating rate determined by market forces and there is no fixed rate which could be considered the correct rate. He added that exchange rate management will have to balance the needs of exporters as well as the other macro economic requirements for maintaining price stability.

3.40 DFAT points out at the political level, the currency crisis might enhance the position of those advocates of *swadeshi* or *India first* economic policies, who would prefer to see an even more cautious approach by government to globalisation of the economy and acceptance of foreign investment.[39]

Economic Outlook

3.41 India on 11 May 1998 conducted three underground nuclear tests and in announcing the tests the Indian Prime Minister said:

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37 DFAT Submission, p. S 991.
38 ibid.
39 ibid.

> The government is deeply concerned, as were previous governments, about the nuclear environment in India's neighbourhood. These tests provide reassurance to the people of India that their national security interests are paramount and will be promoted and protected. Succeeding generations of Indians would also rest assured that contemporary technologies associated with [the] nuclear option have been passed on to them in this, the 50th year of our independence.[40]

3.42 The Prime Minister went on to say that:

> In our neighbourhood we have many friends with whom relations of fruitful cooperation for mutual benefit have existed and deepened over a long period. We assure them that it will be our sincere endeavour to intensify and diversify those relations further for the benefit of all our peoples. For India, as for others, the prime need is for peaceful cooperation and economic development.[41]

3.43 On 13 May 1998, in the face of world condemnation of the 11 May nuclear tests, India conducted a further two tests and drew a strong response from the United Nations Security Council.

3.44 India's major trading partners, including the United States, have imposed economic sanctions. Under US legislation, the administration must cut off all assistance except humanitarian aid to India and withdraw support for loans from the IMF and the World Bank. In addition, all US banks are prohibited from providing loans and credits to India and US Government financing of loans would be terminated. A US ban on technology exports would also go into effect. The US law on nuclear non-proliferation does provide for a 30 day waiver of sanctions that must be approved by Congress. At the time of writing this had not been invoked although US private companies have not been barred from doing business with India.

3.45 The reaction of Australia's Foreign Minister was swift in condemning the Indian action. The Indian High Commissioner was called in and the Australian High Commissioner to India was immediately recalled for consultations. Australia's Prime Minister announced economic and military sanctions against India and recalled the defence attache and military personnel. All defence cooperation and non-humanitarian aid have been suspended and all planned ministerial and senior officials' visits, including a parliamentary delegation visit, have been cancelled.

3.46 Although nuclear testing was part of the BJP's election manifesto, very few believed that the Indian Government would act so early into its term, which was less than two months after the Government was sworn in. India cannot afford to have the threat of sanctions resting over its head with the need for economic reform being an essential element of its economic strategy. Ironically it is the infrastructure projects, such as power plants, roads and refineries on which the BJP welcomed foreign investors, that are in jeopardy for

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40 *AAP*, sourced from Reuters, New Delhi, 11 May 1998, 'India Government statement on nuclear tests', 12 May 1998.

41 ibid.

lack of financing.[42] Moreover investors are worried not just about sanctions but that the military outlays might now increase the GOI's spending, and the deficit is already at 5.5 percent of GDP which the economists say is higher than India can afford if it wants to keep growing.[43] With the announcement of sanctions against India, the Indian rupee fell, with the State Bank of India, a government-owned commercial bank, buying rupees for dollars, perhaps at the behest of the Reserve Bank of India, in what appeared to be a futile attempt to prop up the local currency.[44]

3.47 It is difficult to forecast the medium to long term impact of the sanctions on the Indian economy, and Australia-India bilateral relations, as events will still be unfolding as the Committee reports to the Australian Parliament. However, the Committee is of the view that India's nuclear testing is an unfortunate turn of events that will create a pause in the trade relationship between India and Australia. In the week following the tests, the Indian Government cleared at least fifty foreign investment proposals signaling it will speed reforms to counter US economic sanctions.[45]

3.48 There is a concern that the nuclear testing issue and the resulting sanctions may be the catalyst that leads to the fragmentation of the BJP Coalition. The surfacing of the cycle of political instability and uncertainty that has marked recent Indian Governments will not enhance India's progress on economic development and its reform process.

3.49 The 1997-98 Economic Survey presented to Parliament on 28 May 1998 called for 'bold policy initiatives' to promote industrial investment and growth in the wake of a less friendly external economic environment following the nuclear tests and to achieve macro economic stability and a rapid and sustained GDP growth rate of 7 to 8 percent. The sharp slowdown in GDP and export growth were identified in the survey as two central areas of concern besides slippages on the fiscal front during 1997-98. The fiscal deficit had reached 6.1 percent of GDP as against a target of 4.1 percent in 1997-98.

3.50 The Indian Government brought down its first full Budget on 1 June 1998. In his speech to the Parliament, Finance Minister Yashwant Sinha outlined key objectives of the Budget which are to:

- strengthen the foundations of the Indian economy to deal effectively with an inherently uncertain external environment;
- reverse the decline in agriculture and strengthen the rural economy;
- restore the momentum of industrial growth, especially of small-scale enterprises, and revive the capital market;
- accelerate the development of infrastructure; and by these and other means
- rapidly expand productive job opportunities;

42 *Business Week*, 'And Now for the Fallout: India's tests may bring more trouble than it bargained for', 25 May 1998.
43 ibid.
44 *AAP*, sourced from Dow Jones Newswires, 14 May 1998, 'Rupee falls to all time low vs Dlr', 15 May 1998.
45 *The Australian Financial Review*, 'India responds to sanctions by approving foreign deals', 19 May 1998.

- calibrate the pace and character of integration with the world economy, while strengthening India's international economic position through revival of exports and reduced reliance on borrowed funds;

- ensure macro-economic stability and control over inflation; and

- raise the rate of domestic savings to achieve higher national investment and thus lay the basis for faster medium-term growth. Supplement this effort through foreign investment.[46]

3.51 Major aspects of the Budget include a coherent disinvestment policy, infrastructure development, opening of the insurance sector and a reduction on apparel grade raw wool. An 8 percent levy on imports has been imposed across the board with major exceptions in the areas of crude oil, newsprint, goods imported for subsequent trading and inputs imported under export promotion schemes.

3.52 The provision of economic services such as agriculture and allied activities, irrigation and flood control, power and energy, industry, transport, and communication, are delivered by departmental or non-departmental enterprises and cooperatives and hence a large part of budget support flows as subsidies to public enterprises. As Mundle and Rao point out, these enterprises, which should in principle be contributing surpluses to the budget, have in fact turned out to be a major source of resource drain. This drain, the rising interest of burden of public debt and the failure to control the growth in government consumption expenditure are the three main sources of the secular decline in India's fiscal condition.[47]

3.53 A feature of the full Budget is disinvestment in public sector units. Four profitable enterprises have been targeted for disinvestment.[48] Loss making enterprises are to be closed with redundancy provisions for employees. The Government aims to decrease its shareholding in PSUs to 26 percent and the Government's stake in Indian Airlines is to be reduced to 49 percent.

3.54 Professor Ross Garnaut points out that India is not an integrated economy with a more or less uniform ratio of population to natural resources and capital. It has pockets of excellence, of real comparative advantage in technologically sophisticated production, based on parts of the education system and of capital-intensive industry that were once favoured artificially.[49] As he notes these simple facts carry some large implications - the removal of the suppression of agriculture by raising food prices to international levels can provide powerful support for reform in India. India's large per capita arable land endowment, and the levels of farm income mean, that effective internationalisation and reform of Indian agriculture will help raise farm incomes and output.[50]

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46 *Budget '98,* Budget speech of Finance Minister Yashwant Sinha, New Delhi, 1 June 1998.

47 Exhibit No. 59.

48 IOC - India Oil Corporation; GAIL - Gas Authority of India Limited; VSNL - Videsh Sanchar Nigam Limited; and CONCOR - Container Corporation of India.

49 Exhibit No. 84.

50 ibid.