INDIA ECONOMIC NEWS

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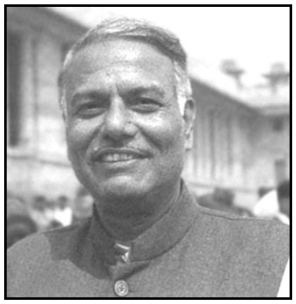
INSIDE:

"India is a cornerstone market for us and we have been consistent in our focus on this country."

— **Philip D. Murphy, Goldman Sachs (Asia) President**

Budget 1999-2000: Salient Features



Yashwant Sinha
Finance Minister

The Finance Minister presented a $66.7 billion budget to Parliament on February 27, 1999 for the financial year 1999-2000 (April 1 – March 31). Explaining the economic context under which the budget has been presented, the Finance Minister said that the year 1998 has been a year of unprecedented global turmoil. India had to contend with the additional challenge of economic sanctions after the May 1998 nuclear tests. While the country has not remained unaffected by these developments, the ***overall performance has been satisfactory***. The ***GDP growth*** in 1998-99 has accelerated to 5.8% compared to 5% last year. Since the beginning of 1998-99, India has added $2 billion to her ***foreign exchange reserves*** and curbed undue volatility in the foreign exchange market. The ***current account deficit*** in the balance of payments is estimated at a modest 1.4% of GDP compared to 1.6% in 1997-98. Although ***inflation*** had risen sharply during the year, it has been brought down to below 5% now.

However, there is no room for complacency, the Finance Minister said. He said that the ***fiscal and revenue deficits*** of both the Center and States are still too high. This is undermining the ability to bring down interest rates, stimulate investment and growth, curb inflationary potential, generate resources for priority expenditure needs and raise exports. He also lamented about the limited impact of the various schemes of the Government on the problems of ***poverty and unemployment***.

The broad strategy of the Budget 1999-2000 is six-fold:

- Begin a medium-term process of revenue and fiscal deficit reduction.
- Undertake a major reform of indirect taxes.
- Deepen and widen economic reforms in all major sectors and accelerate internal liberalization.
- Safeguard the economy from external shocks and revive exports.

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Budget 1999-2000 *(Continued from page 1)*

- Strengthen the knowledge-based industries.
- Revitalize and redirect public programs for human development, encompassing food security, health care, education, employment and shelter.

The salient features of the budget, particularly from the perspective of foreign investors, are:

Taxation

- Major rationalization of ***Excise Duty*** structure: 11 rate categories reduced to 3, with central rate of 16%, merit rate of 8% and demerit rate of 24%.
- ***Customs Duty***: Special customs duty of 5% abolished. Customs duty structure rationalized by reduction of rate categories from 7 to 5. Peak customs duty rate down from 45% to 40%. Surcharge at rate of 10% on basic customs duties imposed as a revenue raising measure.

Foreign Investment

- In order to promote Foreign Direct Investment (FDI) in the ***pharmaceutical industry***, Government has decided to permit up to ***74% foreign equity*** under the automatic route.
- In order to make inflows of FDI hassle free, the Government has decided to ***expand the list of automatic approvals*** covering important industrial and service sectors. The expanded list will be announced separately by the Minister of Industry. Wherever Foreign Investment Promotion Board clearance is required, the decision will be given in 30 days.
- To ensure that FDI approvals are quickly translated into actual investment inflows, Government has decided to create a ***Foreign Investment Implementation Authority*** (FIIA) within the Ministry of Industry, which may also include representatives of State Governments.

Capital Market and Finance

- Income from ***Unit Trust of India*** and other ***Mutual Funds*** to be exempt from income tax in the hands of the unit holders; however 10% tax to be paid by mutual funds on income distributed. To strengthen Unit Trust of India, income distributed under US 64 scheme and other equity-oriented schemes will be exempt from the 10% levy for 3 years.
- The rate of ***long-term capital gains tax*** for resident Indians on transfer of shares and securities has been brought at par with the rate applicable to non-residents at 10% from 20%.

Industry

- The ***Industries (Development and Regulation) Act*** to be reviewed and amended so that the primary focus is shifted to development of industry rather than its regulation.
- New ***Competition Law*** promised to replace MRTP Act.
- ***Information Technology:*** Customs duty on a number of items used in the IT sector reduced. All expenditure incurred in making the computer system Y2K compliant to be allowed as revenue expenditure. Venture capital has been made more attractive to induce high net worth individuals to commit funds to the sector. Requirements of a time-bound investment and a minimum lock-in period have been removed. The guidelines for registration of venture capital activity with the Central Board of Direct Taxes and the Securities & Exchange Board of India have been harmonized to ensure uniformity in norms. Sweat equity and stock options to be taxed as perquisites at the time of exercise of option and as capital gains at the time of sale.

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Budget 1999-2000 *(Continued from page 2)*

- Major direct tax initiative to facilitate industry restructuring through ***mergers and amalgamations***.

Infrastructure

- Infrastructure sector tax holiday extended to ***Power Transmission and Distribution***.
- Massive thrust for ***Road Construction*** to be financed by diesel surcharge. An additional duty of Re.1 per liter of High Speed Diesel Oil to be imposed, half of which will go to the Central Road Fund.

Fiscal Deficit

- The fiscal deficit is likely to be 6.5% of GDP for the financial year 1998-99 as against a budget target of 5.6%. This is to be brought down to 4% of GDP (New Series) during 1999-2000.
- The most effective and lasting solution to controlling expenditure is to begin the process of downsizing Government, the Finance Minister said. To carry this process forward in a systematic way, an ***Expenditure Reforms Commission*** to be constituted.

Housing

- Changes in foreclosure laws to promote housing mortgages.
- Strengthening of housing finance companies through liberal tax treatment of income on non-performing assets. Raising of tax deduction of interest on house loans for self-occupied houses. Increased depreciation allowed for business building houses for employees. Commercial banks to lend up to 3% of incremental deposits for housing.

Gold Deposit Scheme

- New Gold Deposit Scheme supported by tax incentives to mobilize idle gold and thus reduce gold imports.

Budgetary Allocation to Key Social Sectors Increased

- Outlay for Plan programs has been significantly increased in certain priority sectors. For example, there is an increase of 35% in the Agriculture and Allied Activities and 22% in Social Services. The focus of the budget is on basic human development needs such as education, health care, social welfare, housing and water supply.

Economic Reforms

- The Finance Minister said that it is time to seriously debate and decide on ***second generation reforms*** that need to be put in place to make India economically strong and fully capable of competing successfully in the evolving world order. The Government is bringing a Discussion Paper on the subject before Parliament before the end of the Budget Session. The goal is to help build a consensus on the basic issues so that the Government can act more decisively to raise the growth in income, output and employment in the economy to a higher, sustainable level.

Stock markets have reacted favorably to these announcements in particular and the budget in general. The main stock exchange index, BSE Sensex, has gone up by 13% in three trading days after the presentation of the budget.

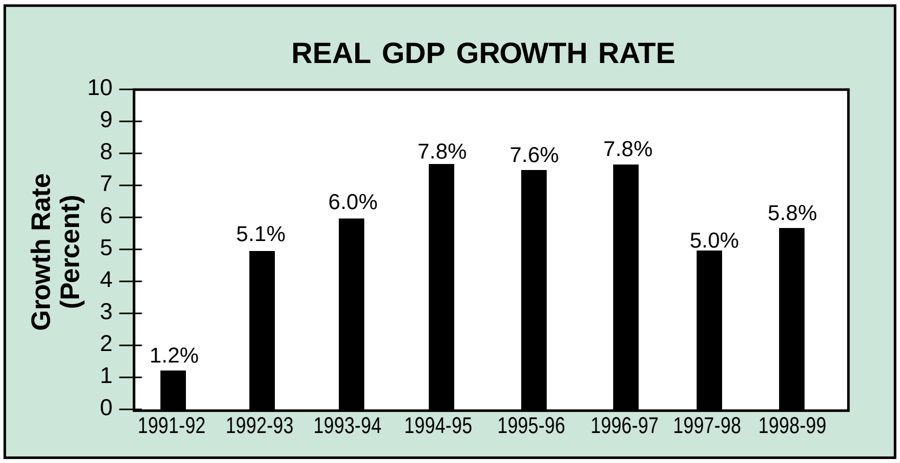
The full text of the Union Budget is available at the Ministry of Finance website at:
http://www.nic.in/finmin

Economic Survey 1998-99: Some Highlights

Economic Survey is the basic economic document of the Government of India that provides a review of developments in the preceding and current years, outlines the prospects for the succeeding year and highlights the policy imperatives. The Economic Survey 1998-99 was released on February 24, 1999. The Indian financial year starts from April 1 and ends on March 31.

Macroeconomic Overview

Economic developments in India in 1998-99 have to be viewed against the backdrop of an exceptionally turbulent and unfavorable international economic environment. The new, 1993-94 based GDP series recently released by the Central Statistical Organization (CSO) shows that ***GDP growth*** decelerated significantly in 1997-98 to 5% from 7.8% in 1996-97. The economy recovered to an estimated growth of 5.8% in 1998-99. The recovery, from the cyclical downturn that started towards the end of 1996-97, would have been firmer but for the East Asian crisis and its effect on world import demand and on international capital markets. Domestic uncertainty arising from non-economic factors also played a role in slowing recovery. Inflation rose sharply during 1998-99, because of an exceptional spurt in prices of a handful of agricultural commodities. The pressure from this source has, however, begun to abate during the last quarter of 1998-99. The inflation rate which peaked at 8.8% in late September dropped steeply from December to below 5% in January. Average inflation for the whole of 1998-99 will, however, be higher than the 4.8% registered in 1997-98.



The deceleration in the growth of India's exports (in US dollar terms) continued for the third year in succession and growth was negative for the first nine months of the year. Imports have decelerated even more sharply, largely because of a decline in the prices of oil and other commodities. The current account deficit consequently fell from 1.6% of GDP in 1997-98 to a projected 1.4% of GDP in 1998-99. Total net capital inflows in 1998-99 are expected to be lower than in 1997-98 as a result of a deceleration in the private inflows. The decline in foreign direct investment (FDI) and commercial borrowing and outflow of portfolio investment by Foreign Institutional Investors (FIIs) have been only partly off set by the inflow under Resurgent India Bonds (RIBs). Despite these trends, foreign currency reserves (exclusive of gold and SDRs) continued to increase in 1998-99, though at a slower rate than in 1997-98. These reserves went up from US $26 billion at the end of March 1998 to $27.4 billion by the end of January, 1999.

Production

After a decline in net ***agricultural output*** by 1% in 1997-98, agricultural value added is expected to rebound by an estimated 5.3% in 1998-99. Food grain production estimated at 192.4 million tonnes in 1997-98 was quite a let down from the preceding year's record output

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of 199.4 million tonnes. The overall prospects of food grain output for 1998-99 are quite good. The 1998-99 food grain output is expected to be about 195.3 million tonnes.

As measured by the Index of Industrial Production (IIP) ***industrial growth*** revived slightly to 6.6% in 1997-98 from 5.6% in 1996-97. This revival however faltered in 1998-99. The growth rate for April-December 1998 was only 3.5%, down from a 6.7% for April-December 1997. The mining sector (includes crude oil) has witnessed the greatest deceleration in growth, from 5.5% for the first nine months of 1997-98 to – 1.1% in 1998-99 (same months). Manufacturing sector growth also fell from 6.9% for the same months of 1997 to 3.7% in 1998. Electricity growth, on the other hand, improved from 6% in 1997 to 6.6% in 1998 over the same months.

The Government initiated ***several reforms*** for providing a stimulus to industrial growth. Coal and lignite, petroleum (other than crude) and its distillation products and bulk drugs were delicensed, as was the very important agro-processing industry, sugar. Coal and lignite and mineral oils were dereserved from exclusive public sector production. The Budget also announced disinvestment of specified portions of equity from select Public Sector Enterprises and a separate policy package for the small-scale sector. Nine items (six from 'farm implements and tools' and three from 'leather') and electronic toys, were removed from the list of industries reserved for exclusive manufacture by the small sector. Companies were permitted to buy-back their own shares subject to restriction of buy-back to 25% of paid-up capital and free reserves. The rules were changed to allow companies to make inter-corporate investments without prior approval of the Government.

In keeping with the firm commitment of the government, and the growing consensus, a number of reforms were introduced in ***infrastructure***, with a view to improving quality, availability and viability. These include the following:

- The Indian Electricity Act, 1910 and Electricity (Supply) Act, 1948 were amended to provide for private investment in power transmission.
- Following enactment of the Electricity Regulatory Commission legislation, the Central Electricity Regulatory Commission was set up, with an enabling provision for states to set up regulatory commissions. A few States have already established such commissions, while a number of them are in the process of doing so.
- Procedures for extending sovereign counter guarantees, to the Fast Track Power Projects which had been held up for some time, have been simplified and several counter guarantees issued.
- Foreign equity participation up to 100% allowed for electricity generation, transmission and distribution (except those of atomic reactor plants) and in construction and maintenance of roads, highways, vehicular bridges, toll roads, vehicular tunnels, ports and harbors. This is subject to the provision that the total foreign equity in any such project does not exceed Rs.15 billion ($353 million at the current exchange rate).
- The tax holiday, granted to the power sector, has been extended up to the year 2003.
- Inland waterways and inland ports accorded infrastructure status for fiscal concessions.

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- The policy for issuing licenses for providing Internet Services has been announced. There will be no license fee for the first 5 years and after 5 years a nominal license fee of Rupee 1 (about 2 cents) will be charged. Private Internet service providers can also set up international gateways after obtaining security clearance.
- Concessions to imports of equipment for construction of National Highways extended to other road construction projects.
- The Urban Land (Ceiling and Regulation) Act, 1976 was repealed by Ordinance. This could contribute significantly towards the development of urban infrastructure including housing, especially in states which have approved the repeal.

Balance of Payments

In spite of a turbulent international environment, India's balance of payments has remained moderately comfortable, with some reserve accumulation. The current account deficit widened to 1.6% of GDP or US $6.5 billion in 1997-98. In 1998-99, it is estimated to fall, as a per cent of GDP, below the level in 1997-98. Net capital inflows are expected to be lower in 1998-99 than in 1997-98 as a result of a deceleration in the inflows of foreign direct investment and commercial borrowing and outflow of portfolio investment by FIIs.

The trade deficit increased from 3.7% of GDP in 1996-97 to 3.9% in 1997-98, despite the sharp deceleration in import growth. This is attributable to deceleration in export growth, which continued for the third year in succession in 1998-99. Export growth slowed from 5.6% in US dollar terms in 1996-97 to 2.1% in 1997-98. Export performance continues to be a major source of concern in the current financial year with exports having declined by 2.9% during April-December 1998, compared to a 3.3% growth in the corresponding period of 1997.

The net inflow on invisible account has continued to be a major support to the balance of payments. Invisible receipts have shown robust growth, reaching US $23 billion in 1997-98. This increase has been spurred by increased private transfer receipts, which have grown by 25% per annum from US $3.9 billion in 1992-93 to US $11.9 billion in 1997-98. Tourism receipts have risen at a rate of 6.8% per annum during the five years ending 1997-98. The receipts under the miscellaneous category in the invisible account, which include software exports, rose from US $1.4 billion in 1992-93 to US $4 billion in 1997-98. ***Software exports*** continue to show exceptional growth rates, and increased by nearly 60% in 1997-98. The net surplus earned under invisibles, excluding the Indian Development Bonds (IDB) return flow in 1996-97, is estimated to have increased from US $9.3 billion in 1996-97 to US $9.8 billion in 1997-98, financing about 60% of the trade deficit in the balance of payments in 1997-98.

The capital account in the balance of payments, which had shown an impressive surplus of US $10.4 billion in 1997-98, is likely to be lower in 1998-99. Total net capital inflows in 1998-99 are expected to be substantially lower than the levels in 1997-98, if the exceptional inflows under Resurgent India Bonds (RIBs) are excluded. Foreign direct investment (FDI), which had increased by 18.6% in 1997-98, has fallen by 38% in April-December 1998. Portfolio investment has continued to decline from US $3.3 billion in 1996-97 to US $1.8 billion in 1997-98, to an outflow of $0.7 billion in April-December 1998. The significant decline in portfolio investment was partly a result of contagion from the East Asian crisis that affected all emerging markets.

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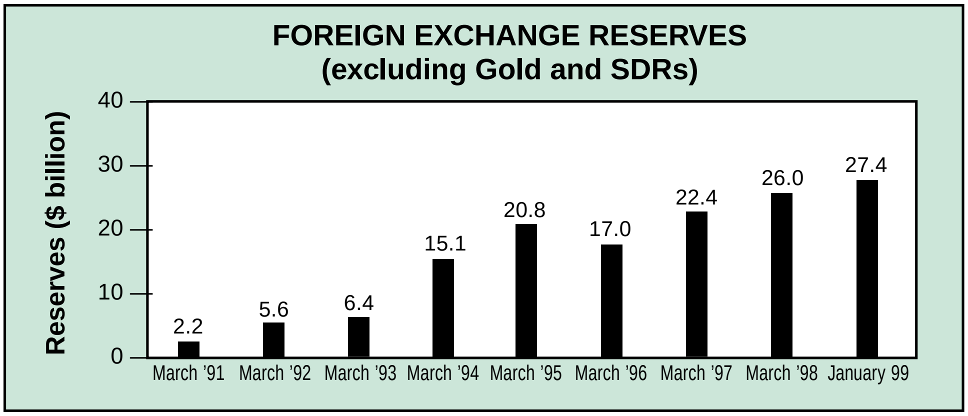


The foreign currency assets of the RBI rose from US $ 22.4 billion at the end of March 1997 to US $26 billion at the end of March 1998. The high surplus in the capital account in 1997-98 outweighed the current account deficit and resulted in an increase in foreign exchange reserves. Total foreign exchange reserves (including gold and SDRs) at the end of January 1999 amounted to US $30.4 billion, which provides cover for about 7 months of imports.

Issues and Priorities

The most intractable and long-standing issue confronting us is that of ***fiscal prudence***. The various aspects of the fiscal problem, namely the fiscal deficit, the revenue deficit, unproductive expenditures and unsustainable subsidies are now fairly well known. With the exception of the initial success achieved in 1991-92 under the pressure of the balance of payments crisis, subsequent improvements have alternated with setbacks and reversals. As a result, the position today is not significantly better than in 1991-92. There is therefore a clear need for building a political consensus on this issue in terms of both constitutional and administrative measures that need to be taken.

Radical reforms in the areas of ***infrastructure services***, agriculture and factor markets are necessary to initiate a virtuous cycle of export growth, employment generation and economic growth. With less than a year left before the start of the 21st century it is perhaps an appropriate time to start preparing for a second generation of economic reforms. Such a reform agenda must include reform of factor markets, public sector, government and other public institutions, legal systems, state level policies and procedures and reform of critical sectors such as infrastructure, agriculture, education, research and development, and agricultural/rural extension.

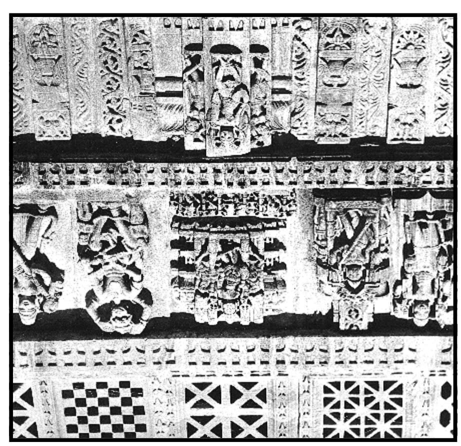
The award of the ***Nobel Prize in Economics to Prof. Amartya Sen*** has again brought home to us (if such a reminder was needed) that growth and development are ultimately about the entitlements of people. Universal literacy and compulsory primary education are necessary not only for sustaining productive employment and economic growth, but also for making every individual a full participant in the democratic life of the nation. The provision of public goods and basic amenities like water, sewage and sanitation must extend not just to the middle class but also to the poorest of the poor. Similarly, strengthening of the norms of civil society and elimination of violence and corruption will bring substantial benefits for the poor. It is critically important to refocus government priorities to those areas which are the basic responsibility of government and to withdraw from areas where private initiatives can often achieve the goals more efficiently.

The full text of the Economic Survey is available at the Ministry of Finance website at: http://www.nic.in/finmin

NEWS BRIEFS

- US private equity firm ***E M Warburg Pincus*** has plans to invest an additional $100 million in India by the end of 1999. Warburg Pincus has already put in $50 million in both private equity and listed Indian companies in media, healthcare and consumer products. Warburg Pincus is also set to take a 20% stake in India's Internet major Rediff On the Net. (Business Standard)
- The Foreign Investment Promotion Board has approved US fast food major ***McDonald's*** proposal to buy properties in Delhi and Mumbai for running its restaurants. According to the proposal, McDonald's will buy the properties in prime locations in the two metros and transfer them to their franchisees for running the Big Mac outlets. (Business Standard)
- Multimedia major Pentafour Software and Exports Ltd. has bagged a contract for the creation of an animated film, scheduled for release in the United States in the summer of 2000. The total budget of the film is estimated to be about $40 million. This is the first project that has come out of a strategic alliance that Pentafour recently forged with Cyber Arrow Technologies, a subsidiary of the US-based ***New Media Venture Partners Inc.*** (Business Standard)
- The California-based pyramidal marketing company ***Herbalife International*** has signed a memorandum of understanding (MoU) with Dominion Chemical Industries, a Bangalore-based bulk drugs manufacturer. Dominion will make food supplements and other herbal products to be marketed in the country by Herbalife. (Business Standard)
- US-based ***Veritas Software Corporation*** has acquired the Pune operations of Frontier Software Development (India) Pvt. Ltd. for a total consideration of $2.5 million. In another move, Veritas has decided to inject $1.2 million in equity in its Indian arm to expand its business and also to set-up an infotech park in Pune. (Business Standard)
- The ***International Correspondence Schools*** (ICS) of USA has joined hands with Jetking, the leading computer hardware and networking institute, to provide long-distance education in India. Jetking has been given the exclusive marketing rights to promote and serve ICS education programs in the country. (Business Standard)

NOTE: This newsletter can also be seen at:
http://www.indiaserver.com



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