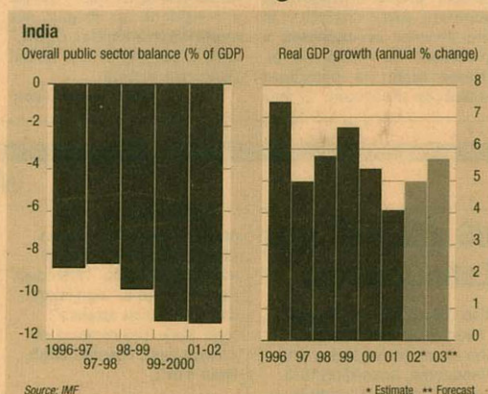
India's stealthy reformer takes the floor

As Jaswant Singh presents his first annual budget, the question is how far he can go, writes Edward Luce



Jaswant Singh, India's finance minister, often admits to being uncomfortable with economics. But in presenting his first annual budget today, Mr Singh's political skills will probably prove much more useful.

With national elections due by October 2004 at the latest, Mr Singh's first priority will be to boost the ruling BJP coalition's chances of victory.

In pursuing this, Mr Singh will almost certainly have to forgo dramatic steps on his other overriding goal, which is to tackle India's large and growing budget deficit. At almost 11 per cent of gross domestic product, India's fiscal deficit is one of the highest in the world.

"The Indian government can do almost nothing it wants to do unless it tackles the fiscal deficit," says Govinda Rao, head of the National Policy Institute for Finance. "But political reality suggests that Mr Singh won't be able to go very far down that road."

Because there is limited scope to reduce spending, the principal focus is on whether Mr Singh will take steps to improve India's paltry level of tax collection, which remains below 10 per cent of GDP. Vijay Kelkar, a senior adviser to Mr Singh, recently produced a controversial report proposing immediate abolition of India's plethora of tax exemptions and a tightening-up of its antiquated tax administration.

But the report, which won approval from most economists, was heavily criticised as "anti-middle class" by Mr Singh's colleagues in the BJP. India's urban middle class provides the core of the BJP's vote base.

Mr Kelkar also recommended doubling the tax threshold to compensate the taxpayer for loss of the exemptions. "The fear is that Mr Singh will implement the popular bits of the Kelkar report and leave the tax exemptions in place," says Surjit Bhalla, a hedge fund manager in New Delhi. "This would make India's fiscal position even worse."

However, Mr Singh is also noted as a skilful tactician and is perfectly capable – in the tradition of his predecessors – of pushing economic reform by stealth.

In spite of India's deteriorating fiscal picture, he has already chalked up a number of important structural reforms since he took office last July.

These include a new law to make it easier for banks to recover assets from defaulters, deregulation of petrol prices, the continued – and unacknowledged – attrition of the bloated public sector payroll, and a revival of India's controversial privatisation programme.

Mr Singh is also assisted by the recent upturn in India's industrial sector, with housing and some manufacturing sectors showing signs of strong growth. He can also rely on the continued double-digit export growth of the country's information technology and business process outsourcing sectors.

In addition, India's rural sector, which accounts for 25 per cent of GDP but provides a living to almost 70 per cent of India's population, has benefited from good rains in the last three months after a terrible drought last summer.

Partly as a result of that drought, the government yesterday revised its growth forecast down to 4.4 per cent for the year ending March 31 – albeit still higher than had been feared.

"Mr Singh is fortunate in inheriting a relatively positive cyclical outlook," said Mr Rao. "But a war in Iraq could blow it off course."

More important, industry and economists have lobbied hard for a budget that starts to address the deep structural problems that hold back India's agricultural economy. Sundeep Waslekar, head of the Strategic Foresight Group in Bombay, estimates that 83 per cent of India remains untouched by the country's economic liberalisation process.

Most of these people still live in the "bullock cart economy" with little or no income to spend on consumer goods, he says. The remaining 17 per cent – most of whom are in the "two-wheeler economy" and a fraction of whom are in the "business class economy" – have benefited handsomely from the dismantling of India's heavily regulated "licence Raj" since 1991.

If that gap is not to widen further, Mr Singh must remove some of the constraints on higher agricultural growth, say economists.

These include outdated laws that compel farmers to sell their produce to government monopoly purchasers, restrictions on the sale of agricultural produce across states, and a land ownership pattern that confines most holdings to one hectare or less.

Farmers are also held back by poor rural infrastructure, with more than a third of India's villagers lacking access to all-weather roads. "The licence Raj is alive and well and it is living in the Indian countryside," said Mr Waslekar. "Most of India's people remain untouched by the much-trumpeted reforms."

There is also strong pressure on Mr Singh to begin reforming India's debt-laden banking sector, which derives most of its income from the generous yields on government debt. Few banks are actively lending to private sector borrowers.

"Mr Singh cannot really afford to do unpopular things before an election," says Mr Rao. "But there are plenty of reforms that he can just slip in quietly."

Investors start to withdraw cash from mutual funds

Investors have withdrawn about Rs50bn ($1.1bn, €970m, £664m) from Indian mutual funds in the past week, signalling an end to a lengthy period of double-digit returns for fixed-income investors, **writes Khozem Merchant in Bombay.**

The outflows have been fuelled by volatility on bond markets, concerns about a possible war in Iraq and uncertainty ahead of today's budget.

Yields on benchmark 10-year government securities have climbed sharply from a low of 5.85 per cent in mid-January to a recent high of 6.75 per cent.

Yesterday, the yield on benchmark securities was 6.47 per cent. Higher yields mean lower bond prices and a fall in the valuation of a typical fixed income fund.

It also signals a reversal to a 30-month period of buoyancy for India's long-term debt funds that was triggered by yields on benchmark securities tumbling from 11.6 per cent in November 2000 to less than 6 per cent, tracking falling domestic interest rates.

With the central bank signalling no adjustment to its "soft bias" towards a rate cut, and yields forecast to continue rising, money managers have concluded that there are limited opportunities in debt securities and have begun selling fixed-income assets.