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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

India: Economic Prospects in 1968

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
March 1968

INTELLIGENCE MEMORANDUM

India: Economic Prospects in 1968

Summary

In spite of last year's record foodgrain crop, India's dependence on foreign economic aid is increasing. The balance-of-payments deficit will be about $1.8 billion in the fiscal year ending 31 March 1968,* more than $200 million above last year, and is likely to rise again next year. The main causes of this growing deficit are:

(1) The need to feed the increasing population and to rebuild food stocks depleted during two years of severe drought will keep food imports very high. Food consumption per capita, although above last year's near-famine level, is still less than three years ago.

(2) The high-priority program to raise agricultural production requires large increases in imports of fertilizer.

(3) The recovery of industrial production from the recent recession is bringing a rise in imports of

* *The fiscal year used throughout this memorandum runs from 1 April of the stated year to 31 March of the following year.*

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industrial materials, most of which were partly freed from quota and exchange restrictions in 1966.

(4) Meanwhile, exports are recovering more slowly than imports, and a part of the increase in exports is being used to pay for rising debt service obligations.

India's balance-of-payments deficit has been covered mainly by aid from the United States and the other members of the Free World consortium, although India also has had to draw on the International Monetary Fund (IMF) and use some of its reserves. [redacted] 25X1 Even with another excellent crop in 1968-69, India probably will need continued large-scale aid to finance rising imports of industrial goods under the more liberal system now in effect and of fertilizer under the program emphasizing agricultural development. Without this foreign assistance, India probably will return to stricter controls over trade and private economic activity.

Even if increased aid is available, the growth of the Indian economy is almost certain to be considerably slower in FY 1968 than in FY 1967, when a record crop raised the gross national product by nearly 10 percent. Agricultural production could increase a little over 1967. If so, however, any increase is likely to be small, since 1967 saw a record crop. Industrial production should continue its recovery, but at a slow pace since the government plans to prevent inflation by holding down expenditures on public investment, thereby keeping the demand for many heavy industrial products depressed. The continued prevalence of large excess capacity in heavy industry makes the Soviet proposals, mainly connected with Kosygin's recent visit, to buy substantial amounts of India's machinery and equipment unusually attractive to India. The USSR has agreed to purchase increased quantities of steel, but there is no evidence that any other such Soviet purchase agreements have been concluded.

Background

1. During the past two years industrial controls and licensing requirements have been removed or greatly relaxed in several areas of economic activity. Reduced controls, together with the June 1966 devaluation and the relaxation of restrictions on imports of most materials and spare parts for industry, were designed to encourage private production and investment. Although these measures constituted a substantial step forward, they did not fully eliminate quota and exchange restrictions. Priority industries accounting for about 85 percent of industrial production were permitted to import their requirements of production materials, but only if such imports were not available from domestic production. Moreover, because of the acute shortage of free foreign exchange, the type of funds to be used for such import transactions -- free foreign exchange, exchange earned in trade with Eastern Europe, and each of the various types of aid funds -- continued to be specified by the government.

2. Even with these shortcomings, decontrol and liberalization measures supported by increased non-project foreign aid were expected to facilitate a substantial increase in industrial production and exports. Before the effectiveness of these measures could be tested, however, India was hit by two consecutive droughts which drastically reduced agricultural production, created near-famine conditions, and seriously hampered industrial activity. Agricultural shortages led to sharply increased prices and to reduced demand for industrial consumer goods. Anti-inflationary fiscal and monetary measures included a reduction in public sector investment which in turn reduced demand for many products of heavy industry. Large excess capacity developed in some sectors such as steel, machinery, and railroad equipment. National income increased only about 2 percent in FY 1966 following a decline of almost 5 percent in FY 1965. The balance of payments worsened as exports of agricultural products fell because of the drought, and a rise in food and agricultural development imports more than offset a decline in imports of industrial goods.

3. In 1967, agricultural production was at a record high, mainly as a result of excellent weather, and industrial production has been improving. As a result, national income increased 9 to 10 percent in real terms. The balance-of-payments deficit increased, however, while new foreign aid commitments declined.

Agriculture

4. The adverse weather conditions of the past two years have ended, and agricultural production will probably increase by from 16 to 20 percent during crop year 1967-68 in comparison with 1966-67. Foodgrain production will be at least 95 million metric tons, about 25 percent above the level of 1966-67 and about 7 percent above the previous high. Principal commercial crops, other than sugarcane, are also likely to be substantially better this crop year. The production of raw jute is expected to increase by more than 20 percent; of raw cotton, by more than 15 percent; and of groundnut, the principal oilseed, by 34 percent. Tea is expected to remain virtually the same, while the output of sugarcane has been adversely affected by some diversion of land to foodgrains, the relative profitability of which has increased. This improvement in agriculture has been principally responsible for the 7-percent gain in exports estimated for 1967.

5. A key element in India's agricultural policy for crop year 1967-68 is the accumulation of a buffer stock of 3 million tons of foodgrains. The public distribution system with rationing at controlled prices is also being continued but with a somewhat reduced coverage. This distribution will require about 10.5 million tons of foodgrain in 1968, compared with between 13 million and 14 million tons per year in 1966-67. To meet stock and distribution targets totaling 13.5 million tons of foodgrain, India plans to procure 6 million tons domestically, compared with 3.5 million tons during the past two years, and to import 7.5 million tons, compared with 9 million tons in 1967. Domestic procurement prices for 1968 have been established about 10 percent higher than last year. Although free market prices are still above the procurement price, they have begun to decline and will probably continue to fall during 1968. The government has announced that it will purchase all foodgrains offered at the present procurement price.

6. India now is giving priority to agricultural development. Tentative targets for FY 1968 include provision of 2.8 million tons of fertilizer, nutrient content (650 thousand more than in FY 1967), planting of 8 million hectares (about 2 million more than in FY 1967) to high yielding seed varieties, and treatment of 55 million hectares (an increase of 4 million hectares) with crop protection materials such as pesticides. Increases in agricultural inputs raised the import bill by about $150 million in FY 1967 and will probably add another $100 million or so in FY 1968.

7. Foodgrain consumption data are little more than educated guesses, principally because of the lack of information regarding farmers' emergency stocks and storage and transit losses. Available data suggest that per capita grain consumption declined in 1966 and 1967 and increased in 1968, but remained below the 1965 level (see Table 1). Imports at or near the 1967 level will be needed in 1968 to maintain the rationing system and to provide for government reserves of 2 million to 3 million tons. The excellent crop in prospect will be used to a substantial extent to replenish farmers' emergency reserves and to improve the rural diet. Some of the grain will move to urban markets, of course, but the increase will be much less than the increase in output.

Industry

8. A large portion of the industrial sector has been in a recession since mid-1966. Food processing fell sharply as a result of a decline in supplies of agriculture materials. Output of nonfood consumer goods, especially cotton textiles, was adversely affected also by a decline in demand -- in rural areas because of reduced incomes, and in urban areas, because the sharp rise in the price of foods cut sharply into incomes available for spending on items other than food. Demand for transport services also fell. In turn, heavy industry suffered from the indirect effects of reduced rural incomes and also from reduced government orders. Output expanded in a few industries, such as fertilizer (which benefited from the agricultural programs), petroleum, and some of the newer export industries.

Table 1

India: Estimated Consumption of Foodgrains
1965-68

	1965	1966	1967	1968
	Million Metric Tons			
Production a/	89.0	72.3	76.0	95.0
Change in government stocks	1.1	0.1	-0.4	-3.0
Imports	7.5	10.4	9.0	7.5
Subtotal	97.6	82.8	84.6	99.5
Change in farmers' and merchants' emergency stocks b/	-6.0	6.0		-6.0 c/
Less feed, seed, and waste d/	11.1	9.0	9.5	11.9
Total available for human consumption	*80.5*	*79.8*	*75.1*	*81.6*
	Kilograms			
Per capita consumption	165	160	147	156
	Million			
Population (midyear)	487.0	498.9	511.3	524.0

a. Foodgrain production is normally reported on a crop year (1 July-30 June) basis. To estimate consumption by calendar year, it was assumed that foodgrain produced in any one crop year is consumed during the calendar year that comprises the last half of that crop year (for example, production in the 1967-68 crop year is consumed in 1968).
b. No precise information available.
c. Minimum.
d. Estimated at 12.5 percent of production, but it may be higher.

9. The recession in the engineering and steel industries can be attributed primarily to the government effort to bring public finance into better balance by reducing (in real terms) public sector investment in the past two years. These industries have been increasing their capacity in the expectation that investment would continue to increase rapidly. The cutback in investment has created large excess capacity.

10. Although industry has not yet fully recovered from the impact of the recession, industrial production has been stimulated somewhat by higher agricultural incomes, by larger availabilities of industrial raw materials, and, with the fall in food prices, by increased demand for such products as cotton textiles. Increased production of cotton textiles should encourage investment for the modernization of textile plants and thereby increase the demand for textile machinery. Production of commercial vehicles should benefit from the larger demand for road transport services to move crops to markets. The process of import substitution, which has been encouraged by the June 1966 devaluation, the advance orders placed by the government for railway equipment, and the selective liberalization of credit effected by the Reserve Bank for capital goods and exports should also contribute to higher industrial production. During January-March 1968, total industrial output will probably be some 5 percent higher than in the corresponding period of 1967, whereas for the entire fiscal year ending 31 March 1968 the increase will be somewhat less than 3 percent. The recovery can be expected to continue through 1968. Much of heavy industry, however, probably will remain depressed because of lack of demand. Planned resources for public sector investment will be less in 1968 than in 1967.

Development Expenditures and Plans

11. Because of the two successive droughts and the economic slowdown that ensued, India scrapped the draft fourth five-year plan, which was to have begun on 1 April 1966. A new five-year plan is being prepared for the period beginning 1 April 1969. Until then, India will operate on the basis of annual plans. To reduce deficit financing and help check inflation,

the government has attempted, without much success, to keep development expenditures at a level consistent with available resources. In FY 1966, deficit financing by the Reserve Bank amounted to 3.4 billion rupees (Rs) ($450 million equivalent), or about one-seventh of total expenditures. Despite plans by the central government to hold the deficit to Rs 140 million (about $18 million equivalent) in FY 1967, the deficit will probably be considerably larger than that in FY 1966. The large above-plan deficit estimated for FY 1967 will result principally from imbalances in state development plans. States do not have to comply with the central government policy of monetary restraint, and they continue to accumulate excessive overdrafts with the Reserve Bank.

12. Even though the government has not been successful in eliminating inflationary deficit financing, the proposed public sector development plan for FY 1968 once again attempts to hold such financing to a minimum -- the annual development plan proposed by the Minister of Finance calls for expenditures of only Rs 20.72 billion compared with Rs 22.5 billion, Rs 22.2 billion, and Rs 22.5 billion (Plan) in FY's 1965, 1966, and 1967, respectively. Although this year's record crop will have a beneficial effect on the economy, substantially increased resources for public sector development will not be immediately or automatically forthcoming. Proposals by the central government, for example, to impose income taxes on the rural sector to mop up a portion of the added agricultural incomes from this year's good crop have been rejected by the states. Pressure from industry for the government to formulate a plan that will substantially increase public sector demand for capital goods, together with pressure from the states for larger local expenditures, will probably result in a larger development plan than that proposed and in continued inflationary deficit financing in FY 1968. Nevertheless, expenditures for public sector development are not likely to be a strong stimulus to the economy in 1968.

13. Private sector investment also has been depressed. The generally difficult economic conditions, political and economic uncertainties, and

more recently, a deterioration in labor relations in some areas, especially in West Bengal, have been important adverse influences. In addition, the higher rupee cost of imported capital goods after the June 1966 devaluation made certain marginal projects unprofitable. Devaluation has had some favorable effects on the incentive to invest in export and import-substitution industries, but so far this positive effect has not been great because of the generally pessimistic attitude toward investment. Also, in some cases investment intentions have been frustrated by the unavailability of capital funds. Industrial profit margins have been squeezed by rising wages, and the new issues market has been in a slump for some time.

Exports

14. The most discouraging aspect of the recent performance of the Indian economy has been that of exports. They declined by about 7 percent in FY 1966 principally because of reduced supplies of agricultural raw materials and adverse foreign market conditions, including lower world market prices for such important Indian exports as tea and jute manufactures. Exports dropped most sharply in the last half of 1966. They began increasing in mid-1967 but still have not fully recovered, and the prospects are for only about a 5-percent increase in FY 1968. Total export earnings are expected to rise to about $1,650 million in FY 1967 (ending 31 March 1968), about 7 percent above the low level of FY 1966, chiefly in response to the growth in supplies of agricultural products. Despite the gain, total export earnings in FY 1967 will only be slightly higher than in FY 1965, and will remain below the $1,686 million level achieved in FY 1964.

15. Primary products (tea, vegetable oils, oil cakes, tobacco, coffee, and cotton), plus jute goods and cotton textiles, normally contribute almost 60 percent of export earnings and are supposed to provide about one-half of a planned annual increase of 8 to 10 percent in export earnings over the next two or three years. This goal is not likely to be achieved, however, because of continued slack world demand, low prices for the two leading exports (tea

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and jute), and the fact that the substantial export taxes introduced at the time of devaluation have more than offset its beneficial effects.

16. The prospects for exports of other manufactures are better. Some manufactured goods, including iron and steel, sugar, and engineering goods, have been given export subsidies of up to 25 percent. These subsidies, along with devaluation and the incentive to export arising from depressed domestic demand (especially in the case of steel), have resulted in some increase in exports. Developing profitable new exports on a large scale and finding foreign markets for them will be difficult, however, and will require much ingenuity and sustained efforts by private businessmen. This is bound to take a long time. Increased exports of Indian manufactures are also hindered by the Indian import policy of protecting even the most inefficient domestic manufacturer. Imports of almost all domestically produced products are banned. This raises manufacturing costs and makes it more difficult for Indian producers to compete in foreign markets.

Balance of Payments and Foreign Aid

17. The poor performance of exports together with the effects of the drought on imports are the main causes of India's worsening balance-of-payments problem. Total imports declined in FY 1966. Imports of machinery and equipment tied to particular foreign aid projects were cut sharply. This cut was mainly attributable to reductions in government investment for internal budgetary reasons. There was sufficient foreign project aid available to maintain higher levels of deliveries, but declines in project-tied imports meant equivalent declines in foreign project aid and so did not save on foreign exchange. Excluding project-tied imports, total imports went up slightly in FY 1966 and grew by more than $300 million in FY 1967. The increase in 1966 consisted of food, not all of which was covered by PL-480 and other emergency aid, and of fertilizer; imports of materials for industry fell. In FY 1967 food imports leveled off, those of fertilizer rose, and imports of industrial materials recovered. In addition, expenditures for debt service have been rising by some $50 million a year. These trends combined to create growing deficits, as shown in Table 2.

Table 2

India: Estimated Balance of Payments
Fiscal Years, 1965-67 a/

	1965	1966	1967
			Million US $
Exports	1,642	1,535	1,650
Imports	2,803	2,693	2,960
Food	598	743	720
Project-tied	729	560	520
Fertilizer	82	127	280
Other imports b/	1,394	1,263	1,440
Trade balance	-1,161	-1,158	-1,310
Other transactions	-267	-434	-512
Debt service	-270	-320	-370
IMF repayments	-75	-57	-57
Others, net c/	78	-57	-85
Overall deficit	*1,428*	*1,592*	*1,822*
Financed by:			
Food aid and other PL-480	526	586	510
Project aid	729	560	520
IMF drawings	137	187	90
Use of reserves (decrease +)	-101	-9	N.A.
Nonproject aid	137	268	702 d/

a. The fiscal year runs from 1 April of the stated year to 31 March of the following year.
b. Consisting principally of maintenance imports -- that is, raw materials, spare parts, and the like, plus a small amount of capital goods not financed by project-tied aid.
c. Including invisibles, autonomous capital movements, errors, and omissions.
d. Residual.

18. The balance-of-payments deficit, excluding project aid, rose by about $300 million a year, from about $700 million in FY 1965 to more than $1 billion in FY 1966, and around $1.3 billion in FY 1967. The trend is unaffected if food aid and other PL-480 aid is deducted -- the deficit rises from less than $200 million in 1965 to more than $400 million in FY 1966 and nearly $800 million in FY 1967. The Free World aid consortium covered most of this deficit through aid commitments of $900 million in FY 1966 and $350 million to date (including debt-deferrals) in FY 1967. Because much of this aid is tied not only to the country extending it but also to particular products, deliveries have been slow, and an estimated $400 million to $500 million remain to be used. To cover the remainder of its deficit, India has had to borrow from the IMF to the extent of $275 million in the past two years and use some of its foreign exchange reserves, which fell by $37 million between November 1966 and November 1967, when they amounted to $563 million, or about two months' imports.

19. According to the World Bank, India in FY's 1968 and 1969 will need new aid commitments averaging about $800 million annually, excluding both project aid and US PL-480 aid, the latter of which is assumed to remain around $400 million. As indicated earlier a slow growth in exports is to be expected. Food imports may decline a little in FY 1968, but this decline will be more than offset by increases in imports of fertilizer and other agricultural inputs. Imports of materials for industry should continue to rise at a moderate rate. The balance-of-payments deficit in FY 1968, excluding imports financed by project aid and PL-480, is likely to amount to between $800 million and $1 billion. The prospective deficit would have been much greater if the IMF had not agreed to postpone until some time in FY 1970-71 certain repurchase obligations totaling $387 million originally due in FY 1968.

20. India's foreign exchange deficit in the latter part of FY 1968 and especially in FY 1969 will, of course, be affected by the weather for agriculture. Another year of good weather, together with the effects of increased inputs of fertilizer, should enable India to begin reducing its dependence on food imports. But the foreign exchange thus saved could

be used to import substantially more industrial materials and other goods only if foreign aid is not cut. Foreign aid does not ensure that India will continue present policies liberalizing trade, encouraging private investment, and giving priority to agricultural development. But lacking sufficient foreign aid India probably will encounter an increasingly severe foreign exchange bottleneck and will thus be tempted to return to a system of tight controls over all imports and private activity.

Soviet Trade and Aid

21. In the recent past, India's economic relations with the USSR have not been contributing to the solution of the Indian balance-of-payments problem. Indo-Soviet trade (excluding Soviet military exports) has expanded rapidly from about $12 million, or less than 1 percent of India's total trade, in 1955 to about $384 million, or 9 percent of total trade, in 1966. During 1961-65, India's imports from the USSR ($892 million) considerably exceeded its exports to the USSR ($577 million), reflecting substantial deliveries under Soviet economic aid agreements. India's bilateral trade deficit with the USSR declined rapidly after 1963, however, as Indian exports rose while Indian imports declined, and Indo-Soviet trade in 1966 was about balanced. The closing of the gap was caused by increased repayments by India of earlier Soviet economic and military credits and by a decline in 1966 in Soviet aid deliveries. [redacted] 25X1

[redacted] Excluding aid deliveries and repayments, India had a substantial trade deficit with the USSR in both 1966 and 1967, which probably resulted in an accumulation of Indian indebtedness on clearing account.

22. There is little that the USSR can do to ease India's balance-of-payments problem through its existing economic aid program, which consists almost entirely of project aid. Deliveries of Soviet aid have been restricted mainly because of India's own

domestic budget problems. Moreover, India's growing repayments of Soviet credits are made principally with the same kinds of products that it sells on world markets (for example, jute products and tea). It is possible, however, that the USSR will begin to import larger quantities of Indian industrial products, such as railroad cars and steel which are difficult to sell on world markets. Following Premier Kosygin's visit to India in January 1968, there were reports of Soviet offers to greatly increase purchases of Indian heavy industrial products. One agreement for the USSR to purchase some 600,000 tons of steel during the next three years has recently been concluded. Although it is not known whether any additional agreements were signed, substantial Soviet purchases of such products would help to stimulate recovery of India's heavy industry from its current recession, while directly aiding the performance of industrial projects built with Soviet aid.