India

The economy is making a strong recovery from the slowdown in FY2008. Still, to return to the high-growth plateau of precrisis years, successful resolution of several macroeconomic management and reform challenges is needed. These include maintaining export competitiveness by ensuring the right balance between the exchange rate and inflation, continuing the fiscal consolidation, improving agricultural productivity, addressing infrastructure bottlenecks, and sustaining investor confidence. For the current fiscal year, this *Update* slightly lifts the forecast for GDP growth, but raises the estimate for inflation and widens the forecast for the current account deficit. In FY2011 these variables are expected to improve relative to FY2010.

Updated assessment

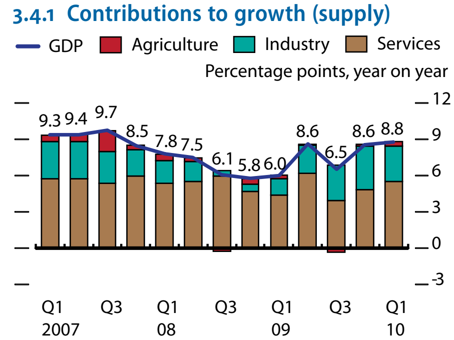
The complexity of macroeconomic and monetary management has become knottier since the publication of *Asian Development Outlook 2010* (*ADO 2010*) in April this year. Strong, well-timed macroeconomic policies cushioned the impact of the global downdraft and must now be wound down without their endangering the robust recovery that took hold this year. However, high headline inflation (triggered by high food prices due to structural supply constraints) and a strengthening rupee in real terms (mainly driven by relative prices), posed problems for monetary management.

Moreover, the rapid pace of the recovery has driven imports up and the trade deficit out. But capital inflows have been buoyant, and therefore policy needs to take into account their possible volatility, stemming from a sudden rise in risk aversion in global markets as well as any sustained erosion in India's export competitiveness.

GDP growth of 8.8% in the first quarter of FY2010 (ending March 2011) and 8.6% in the last quarter of FY2009 signaled a strong and (so far) durable recovery, primarily led by a healthy expansion in industry and buoyancy in services (Figure 3.4.1). Moreover, the performance of agriculture was reasonable in the first quarter, after a negligible expansion in FY2009 due to a poor summer monsoon. The subsectors that registered impressive growth included mining and quarrying; manufacturing; electricity, gas, and water supply; construction; and trade, hotels, transport, and communications.

From the demand perspective, investment took over as the major driver of growth in the second half of FY2009, from government consumption expenditure in the first. Indeed, investment contributed nearly one-half of GDP growth for the second half of the fiscal year. This revival was primarily due to an improved overall business outlook and the desire for greater production capacity following slow investment the previous year. Rapid growth in investment likely continued in the

3.4.1 Contributions to growth (supply)



Note: Fiscal quarters.

Source: Ministry of Statistics and Program Implementation. http://www.mospi.nic.in (accessed 31 August 2010).

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This chapter was written by Hiranya Mukhopadhyay of the South Asia Department, ADB, Manila.

first quarter of FY2010 (though preliminary GDP expenditure data are indeterminate because of a very large unclassified item).

Monthly manufacturing output data supplement the first-quarter GDP data to reveal the pattern of current expenditures (Figure 3.4.2). The bulk of improvement in manufacturing growth came from the capital goods and consumer durables goods sectors in FY2009, and this trend continued in early FY2010. Robust pickup in capital goods (apart from a revival in private sector investment) was in part attributable to higher spending on infrastructure. Automobiles, consumer electronics, home appliances, and other household products led the impressive performance of consumer durables.

Persistent high inflation somewhat mars the economic landscape. The year-on-year rate picked up to 11.0% in April 2010, and subsequently moderated to 8.5% in August (Figure 3.4.3). While initially bumped up by a surge in food prices reflecting a poor harvest, high food inflation appeared to be seeping through to wages and then to prices for manufactured goods, where inflation climbed to 6.4% in April, but subsequently slowed to 4.8% in August as monetary tightening gained traction.

Food price inflation stayed high at 14.6% in August 2010—despite record levels of government food stocks and a good spring harvest—adding further to popular discontent over continued high prices. (A June revision in domestic prices of petrol, diesel, cooking gas, and kerosene, while a welcome step in reducing high subsidies, has also nudged up overall inflation.)

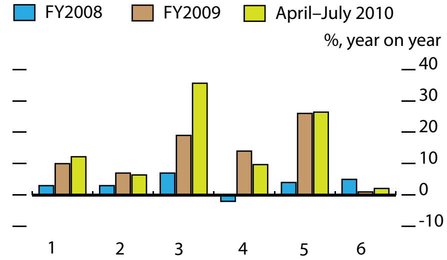
Still, the government expects inflation to moderate in the second quarter of FY2010 and beyond because this year's summer monsoon rainfall has been above average and a bumper agricultural outturn is expected to bring down food prices. The Reserve Bank of India (RBI), the central bank, expects that overall inflation will moderate to 6% year on year by end-March 2011.

In the context of the strong domestic recovery and inflation pressures, the RBI began a gradual withdrawal from its earlier expansionary monetary policy stance. It raised both the repo and the reverse repo rates by 125 and 175 basis points, respectively, from January to mid-September this year (Figure 3.4.4). It lifted the cash-reserve ratio by 100 basis points in the same period. In announcing the September decision to adjust rates (the first mid-quarterly policy review undertaken to better guide market participants), the central bank noted that India's recovery was rapidly converging to its trend rate of growth.

Strong momentum in industrial production, buoyant services sector indications, a favorable outlook for agriculture, and fiscal consolidation on its targeted path underpinned this assessment. Inflation remained the dominant concern and the upward rate adjustment would contain it and anchor inflationary expectations without disrupting growth.

On the external front, the central bank noted that the continued sluggishness of the global economy was constraining export growth, while the strong domestic recovery was pushing imports and the trade deficit higher. However, improved global investor sentiment was resulting in increased capital inflows and, if it continued, it would abate concerns even if exports remained sluggish.

3.4.2 Growth in manufacturing (use based)



1 = manufacturing; 2 = basic goods; 3 = capital goods; 4 = intermediate goods; 5 = consumer durables; 6 = consumer nondurables.

Note: Revised series adopted 14 September 2010, with base year = 2004–2005.

Source: CEIC Data Company (accessed 13 September 2010).

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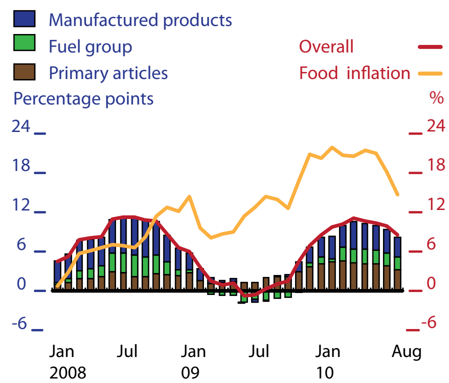
3.4.3 Contributions to inflation



Source: Ministry of Industry and Commerce. http://eaindustry.nic.in (accessed 17 September 2010).

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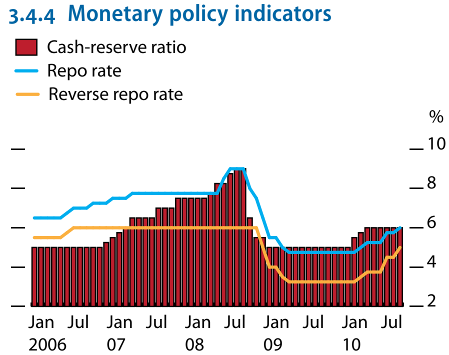
3.4.4 Monetary policy indicators



Source: CEIC Data Company (accessed 16 September 2010).

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In its statement, the RBI also indicated that policy adjustments over the year had brought back the high expansionary stance of policy to a more neutral position. With normalization largely complete, adaptations in central bank policies would now essentially be oriented to changing current and expected macroeconomic conditions.

The monetary measures have had a discernible effect on credit conditions. The call money market rate increased from a high of around 3.4% in December 2009 to 6.1%–9.0% by end-July 2010. Despite firming interest rates, the recovery in growth in bank credit to the commercial sector that began in November continued to be strong through August 2010 (Figure 3.4.5).

The key features of India's balance of payments during FY2009 were a slightly lower trade deficit (though it expanded over the year as the return to rapid growth sucked in imports); a weakening in the invisibles account surplus (because of slower growth in business processing services); and a marked widening in the current account deficit to $38.4 billion (to 2.9% of GDP) (Figure 3.4.6).

An encouraging development was the burgeoning of net capital inflows during the year, as risk appetite returned with the upswing in growth in major industrial economies. The capital surplus more than covered the current account deficit and helped to rebuild foreign exchange reserves following the large loss in FY2008. India's external debt, as of 31 March 2010, was at $261.4 billion (18.9% of GDP).

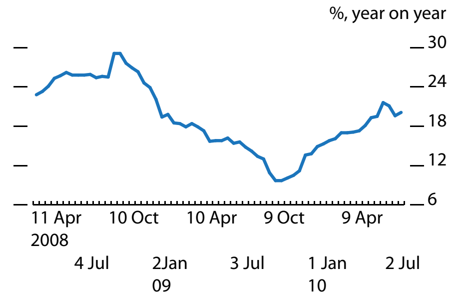
Balance-of-payments data for the first quarter of FY2010 are not yet available. Exports accelerated their post–October 2009 revival, surging by 34.4% in the first quarter of FY2010 (Figure 3.4.7), though this steep gain was partly due to the previous year's low base. The first quarter's stars were petroleum products (up 80%), gems and jewelry (36%), textiles (30%), and engineering goods (16%). Imports also leaped, registering growth of 35% in the first quarter. Data through August, however, indicate a marked slowing in exports versus an accelerating import pickup, widening the trade deficit.

Foreign exchange reserves fell slightly in the first fiscal quarter but subsequently advanced to show roughly a $4 billion gain over the first 5 months of FY2010, to total about $258 billion at end-August (Figure 3.4.8). This increase in reserves (though less than the $20 billion in the period a year earlier), suggests that, in the face of a growing trade deficit, net capital inflows stayed strong. Indeed, portfolio investment by foreign institutional investors amounted to $12.2 billion in the first 5 months of FY2010, some 20% above the prior-year level.

Despite some moderation in capital inflows in the first quarter of FY2010 (especially in May), and consequent nominal depreciation of the rupee against the dollar, the pressure on the rupee to appreciate has reemerged due to strong capital inflows in the second quarter. Indeed, the Indian currency appreciated by more than 11% in real terms between August 2009 and August 2010 (Figure 3.4.9). This was mainly attributable to high inflation (relative to trading partners). The authorities are keen to push growth to 9%–10% over time, and so may want to resist any appreciation in the exchange rate and to this end the expected reduction in inflation over the coming months will be beneficial.

Given the volatile nature of capital inflows in reaction to external

3.4.5 Credit growth to private sector



Source: Reserve Bank of India. http://www.rbi.org (accessed 13 September 2010).

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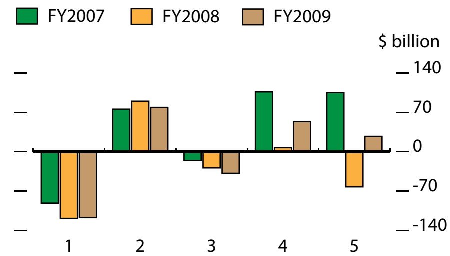
3.4.6 Balance-of-payments indicators



1 = trade balance; 2 = invisibles balance; 3 = current account balance; 4 = capital account balance; 5 = change in reserves including valuation changes.

Source: Reserve Bank of India. http://www.rbi.org (accessed 11 September 2010).

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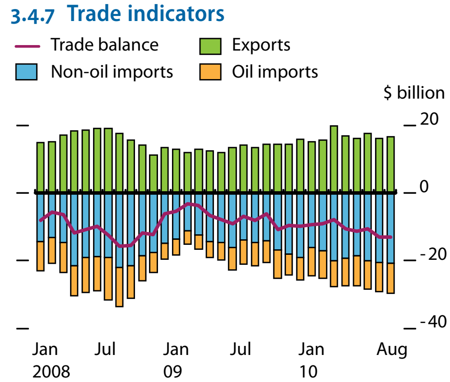
3.4.7 Trade indicators



Note: Total exports and imports based on customs data.

Source: Ministry of Commerce. http://commerce.nic.in/index.asp (accessed 16 September 2010).

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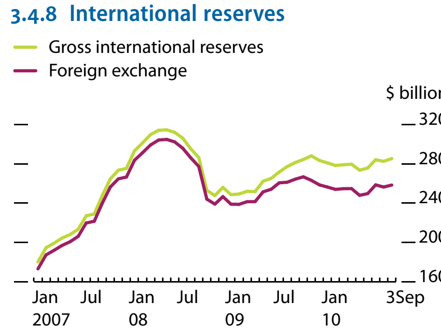
3.4.8 International reserves



Note: Gross international reserves includes gold and SDRs.

Source: CEIC Data Company (accessed 15 September 2010).

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events, striking the right balance among growth, inflation, and competitiveness objectives will be a delicate maneuver. A continued stable recovery in the industrial world should sustain positive global investor sentiment, and hence capital inflows to India.

Amid uncertainties about global recovery, the central government's FY2010 budget deficit was set to decline to 5.5% of GDP, about a 1.2 percentage point reduction as part of a multiyear plan for winding down the large fiscal stimulus provided earlier (Figure 3.4.10). Receipts from the sale of bandwidth for mobile telephony and wireless broadband in auctions turned out to be almost three times the budgeted amount; however, the additional funds were largely offset by a Rs.546 billion supplement to the budget that raised total expenditure by about 5%. Data through August show buoyant revenue collection, such that the deficit target should be readily met.

The June 2010 the government's decision to decontrol gasoline (petrol) prices—allowing them to adjust to global prices—as well as raising administered prices for diesel, cooking gas, and kerosene was a step in the right direction. While further actions are needed, the changes were an important start to reducing excessive subsidies and rationalizing incentives for energy use and production.

The introduction of a comprehensive, integrated (federal and state) goods and services tax (GST) to replace a myriad of indirect taxes is also a crucial reform both for achieving fiscal consolidation as well as minimizing distortions in the economy. It was expected to take effect from April 2011; however, it has been delayed as procedural requirements were not completed in time. Moreover, the revised version of the direct tax codes, approved by the Cabinet recently, appears to be a missed opportunity for fundamental reforms in the direct tax system. That version, too, will not take effect in April 2011 as originally planned.

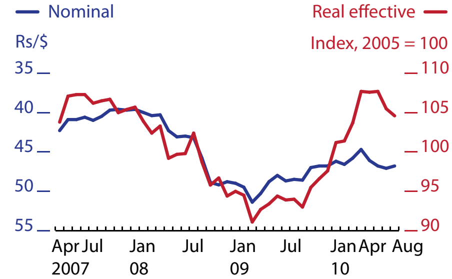
Despite renewed buoyancy in revenue stemming from higher growth, greater rationalization in expenditure will be needed to achieve the fiscal consolidation roadmap proposed by the 13th Finance Commission. That document envisaged the central budget deficit shrinking to 3.0% by FY2013 and the general government debt to 68% of GDP (from 80% at end-FY2009).

The Sensex, the main index of the Bombay Stock Exchange, saw a remarkable runup from March 2009 that has continued through August 2010 (Figure 3.4.11). The upturn was part of a general worldwide rally in stock prices. The Sensex has substantially outperformed a general index of emerging Asian stock markets—the Morgan Stanley Capital International All Country Asia Pacific (excluding Japan)—whereas they had often moved in virtual lockstep before.

Prospects

ADO 2010 forecasts for FY2010 and FY2011 were based on six key assumptions: monetary and fiscal stimuli would be withdrawn gradually over the next 2 years; the domestic food supply position would be comfortable because of normal monsoons; international oil prices would average about $80 per barrel in 2010 and $85 in 2011; domestic fuel prices would be revised upward; industrial economies would show modest

3.4.9 Exchange rates



Sources: CEIC Data Company; Bank of International Settlements. http://www.bis.org (both accessed 13 September 2010).

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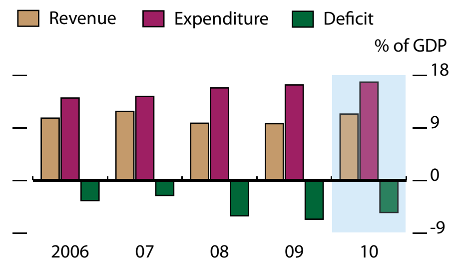
3.4.10 Central government budget indicators



Note: FY2010 is an estimated budget outcome that includes the proceeds from telecoms auctions.

Source: Ministry of Finance. http://indiabudget.nic.in (accessed 16 September 2010).

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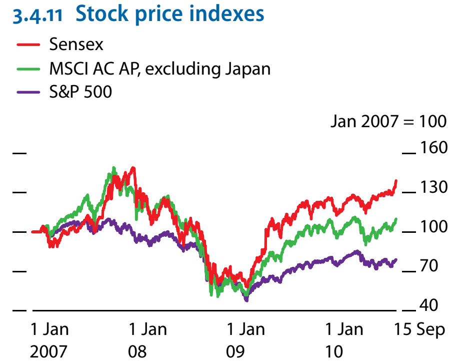
3.4.11 Stock price indexes



MSCI AC AP = Morgan Stanley Capital International All Country Asia Pacific.

Source: Bloomberg (accessed 15 September 2010).

Click here for figure data

3.4.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	8.2	8.5	8.7	8.7
Inflation	5.0	7.5	5.5	5.5
Current acct. bal. (share of GDP)	-1.5	-2.7	-2.0	-2.4

Source: ADB estimates.

recovery in 2010 followed by further acceleration in 2011; and world trade would grow by 7%–8%. The main differences in assumptions between this *Update* and *ADO 2010* are moderation in growth in industrial economies in 2011; and faster growth in world trade in 2010 (9.5%) followed by a deceleration in 2011 (to 8.1%).

The positive response to monetary policy accommodation and fiscal stimulus are still boosting growth prospects in FY2010. The improved business optimism is reflected in several business confidence surveys (Figure 3.4.12, for example). Similarly, despite some moderation in the 50th round of the Industrial Outlook Survey of RBI for the assessment quarter (April–June 2010) as well as expectations for the July–September 2010 quarter, growth impulses remained very strong. Moreover, the HSBC Markit Purchasing Managers' Index for manufacturing has since January 2010 been sustained at a relatively high level (Figure 3.4.13).

Sustained business optimism and rebounded corporate earnings in the second half of FY2009 are likely to support new investment, despite a hardening of interest rates in recent months. Profit after tax of nongovernment, nonfinancial, listed companies increased by 44% in the last quarter of FY2009 as against a decline by 20% in the same period of FY2008. Strong private investment demand is corroborated by the commissioning of new projects. Industries like construction, road infrastructure, shipping, automobiles, cement, paper, and fertilizer are expected to see substantial project commissioning in the current fiscal year. This will generate demand for capital goods.

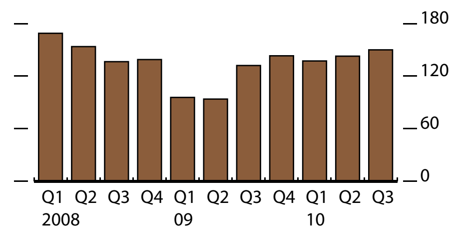
As argued in a recent RBI report, a buoyant stock market can also be conducive for domestic investment and growth. For example, rising asset prices (originating from rising stock price) would lead to improvement in the balance sheets of firms and banks, and hence easier access to funding at lower cost. The wealth effect could also exert a positive influence on private consumption.

Revival in private consumption is critical to maintaining the appetite for private investment demand. Higher disposable incomes (after an announcement of increased personal income tax limits in the last budget) will boost private consumption and the demand for consumer durable goods. Buoyancy in corporate wages will also boost urban consumption, while normal agricultural growth, expansion of the National Rural Employment Guarantee Scheme, and a higher minimum support price for pulses will strengthen rural demand for consumer durable goods and automobiles.

Despite a pickup in exports, the positive contribution of net exports that resulted from the sharper import decline in FY2009 will revert to the normal negative pattern in FY2010 as domestic demand and imports strengthen. The overall growth outlook, thus, will essentially be shaped by the renewed buoyancy in domestic absorption in FY2010. The overall GDP growth rate is expected to be 8.5% during FY2010, a touch stronger than the 8.2% projected in *ADO 2010*. The growth momentum is expected to carry on in FY2011 despite slight moderation in growth in industrial economies and world trade. In view of these developments, the growth forecast for FY2011 remains unchanged at 8.7% in FY2011 (Figure 3.4.14).

In contrast, the inflation forecast for FY2010 is raised substantially. Running against expectations in *ADO 2010*, inflation pressures did not

3.4.12 Dunn and Bradstreet optimism index



Note: The index is calculated as the ratio of the positive responses for six selected parameters (or "subindexes") for the period under review to the positive responses in the base period (Q2 1999).

Source: Dunn and Bradstreet India. http://www.dnb.co.in (accessed 31 August 2010).

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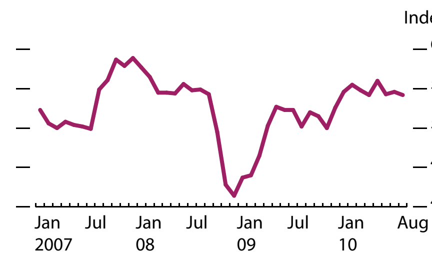
3.4.13 HSBC India manufacturing purchasing managers' index



Source: Bloomberg (accessed 10 September 2010).

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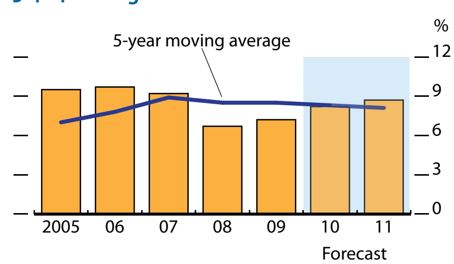
3.4.14 GDP growth



Source: Asian Development Outlook database.

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ease after the winter crop (harvested in April–June 2010), and the second-order impact of higher food and fuel prices remains an issue. However, overall year-on-year inflation is expected to decline by March 2011 due to a recovery in summer sown crops in 2010 (harvested in September–October), and the favorable impact of a high base in the second half of FY2009.

Nevertheless, projected average inflation will remain elevated at 7.5% in FY2010 despite sequential falls in the year-on-year rate. As nonfuel commodity prices slacken in 2011 and domestic production and stock of foodgrains remain comfortable, overall inflation is expected to moderate to 5.5% in FY2011 (Figure 3.4.15).

As forecast in *ADO 2010*, trade flows in FY2010 and FY2011 will strengthen, though less quickly than before the global slowdown, primarily due to the pull factor originating from the buoyancy in world trade and domestic growth. Exports are projected to grow by 18.0% in FY2010 and 15.0% in FY2011. Imports will maintain a relatively stronger growth (20%) in FY2010 due to buoyancy in investment and domestic industrial production before moderating to 18% in FY2011.

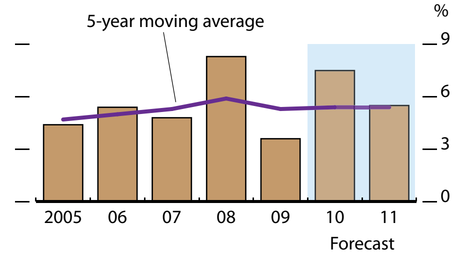
Sectors such as information technology (IT) and IT-enabled services, gems and jewelry, and agricultural and allied products are expected to post impressive export performance in the forecast period. Overall, the current account deficit as a share of GDP will remain relatively high at around 2.7% in FY2010 and 2.4% in FY2011 (Figure 3.4.16).

The possibility of surging capital inflows and, consequently, an excessive surplus in the capital account cannot be ruled out. This would pose a challenge for macroeconomic management in the coming months. Prolonged low interest rates in the major industrial economies could exacerbate the flow of short-term capital to India, leading to a complex balancing act between inflation and the nominal exchange rate. If Indian inflation does not abate as expected, the RBI would find it difficult to intervene in the foreign exchange market to damp rupee appreciation, due to limited options for sterilization.

A well-grounded, robust recovery will depend on the ability of the various levels of policy makers to coordinate effectively among themselves and achieve macroeconomic stability. There are two interrelated threats to stability: continued appreciation of the rupee as well as high actual inflation and inflation expectations. The former could jeopardize recoveries in many labor-intensive export-oriented industries, and the latter could force the central bank to take a sharply tighter credit policy, stunting growth.

The other downside risk to the growth forecasts is that the recovery in industrial economies will stall or an event that may shock global credit markets. Clearly, any renewed weakness in the external environment would deflate current positive trends.

3.4.15 Annual inflation



Source: Asian Development Outlook database.

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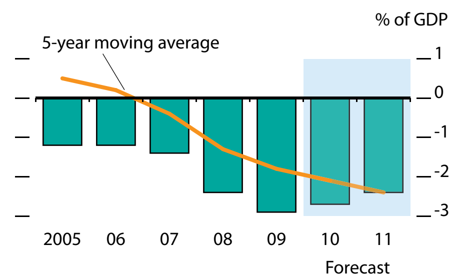
3.4.16 Current account balance



Source: Asian Development Outlook database.

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