India

The economy rebounded strongly over the past fiscal year and is among the leaders in exiting the global recession. Prompt and strong fiscal stimulus and monetary easing, an improving global economic environment, a return of risk appetite, and large capital inflows were instrumental in the bounceback. Rising inflation, however, is a concern. Monetary tightening and withdrawal of fiscal stimulus are under way. The outlook is for a return of high growth, though this will require continued apt handling of macroeconomic policies. To sustain long-term growth, addressing infrastructure bottlenecks and reforming agriculture are essential.

Economic performance

Starting slowly in the first quarter of FY2009 (ending March 2010), economic growth in India came back strongly over the year (Figure 3.17.1), buoyed by monetary and fiscal stimulus and by gradually strengthening consumer and private business confidence. The government's advance estimate for the year put GDP growth at 7.2%, a marked improvement over the 6.7% recorded in FY2008 (Figure 3.17.2).

At the sector level, industry fully accounted for the improvement in growth as manufacturing output spurted (Figure 3.17.3) from the very beginning of the fiscal year to be 8.9% higher than a year earlier. Manufacturing's impressive performance signals that the economy has regained the momentum lost at the onset of the global financial crisis.

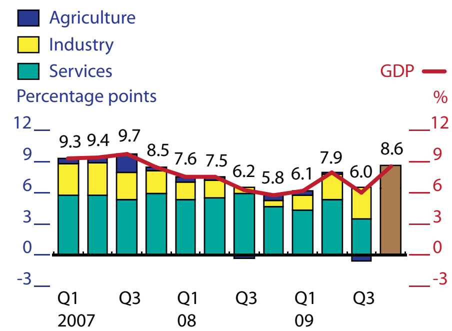
Agriculture played no role in the upturn: output is estimated to have fallen by 0.2% for the year, reflecting the poor summer monsoon. The impact of this output decline was largely felt in the third quarter, and the upward trend in growth faltered temporarily as farm production fell by nearly 3% year on year.

Expansion in services, while a healthy 8.7%, slowed from a year earlier. This reflected a more moderate pace of spending by the government on compensation to employees reflected in slower growth of social services.

On the demand side, preliminary data suggest that robust contributions by private and government consumption continued, but also that investment failed to show any signs of pickup with the fixed investment-to-GDP ratio slipping marginally to 32.3%. Restocking of inventories also added to GDP growth after a large drop a year earlier, helping boost growth in manufacturing output. Civil servants' wage hikes, low interest rates, and rising consumer confidence led to a surge in vehicle sales during the year; production data indicate sales strength of other durable items as well. Net exports also bolstered growth, reflecting a drop in imports.

Indian corporations made the most of lower commodity prices and

3.17.1 Quarterly contributions to growth (supply)



Note: Q4 2009 sector breakdown not given.

Sources: Ministry of Statistics and Program Implementation. http://www.mospi.nic.in (accessed 2 March 2010); ADB estimates.

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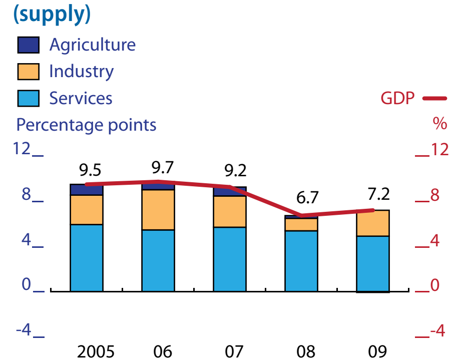
3.17.2 Annual contributions to growth (supply)



Source: Ministry of Statistics and Program Implementation. http://www.mospi.nic.in (accessed 24 March 2010).

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This chapter was written by Hiranya Mukhopadhyay of the India Resident Mission, ADB, New Delhi.

the government's cut in excise duty in response to the global crisis. Companies curtailed their expansion plans, reduced marketing expenses, and went slowly on granting pay rises to their staff. These moves, along with falling interest rates, helped them report a 28% rise in after-tax profit in the first half of FY2009.

The outline of the improving economic landscape is, however, blurred by a recent surge in inflation to 10% in January 2010, largely propelled by food inflation that reached 20% in December 2009 (Figure 3.17.4). The very weak summer monsoon in the sowing season, followed by widespread flooding later, has triggered a spurt in food prices. Importantly, escalating prices have not been confined to cereals but include pulses, vegetables, and poultry products, pointing to the government's inability to stabilize prices by the usual buffer-stock operations. With the rise in the second half, inflation is estimated to average 3.6% in FY2009.

Beyond weather, one structural reason for persistent price pressure is that the central government has raised its food procurement prices greatly (the minimum support price for paddy has gone up substantially over the past 3 years).

The government took several supply-side measures to counter the recent surge in prices, including selling wheat and rice from buffer stocks, temporarily suspending duty on sugar imports, and initiating measures against hoarding. While food prices are expected to moderate with the new harvest season, their relentless rise (given their large weight in the price index) has created concerns of spillover to nonfood prices and a ratcheting up of inflation expectations.

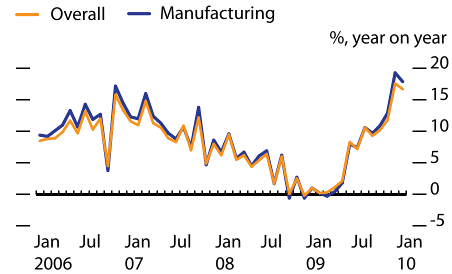
Uncertainties about domestic fuel prices (which again require heavy subsidies as global oil prices climb) are also contributing to inflation expectations. The Parikh committee, which took on the contentious issue of domestic pricing of petroleum products, recommended complete deregulation of petrol (gasoline) and diesel prices, and substantial increases in the prices of cooking gas and kerosene.

This is, indeed, a much-needed reform because of high subsidy costs and harm to the long-term health of the petroleum industry, which bears part of the subsidy costs. Implementation, however, will be challenging at the moment due to accelerating inflation and higher duties imposed on crude oil, petrol, and diesel in February 2010 that were passed on by adjustments in administered sale prices.

The Reserve Bank of India (RBI) signaled the beginning of an exit from its crisis policy stance at its January 2010 policy meeting when it raised banks' cash-reserve ratio from 5.0% to 5.75% (Figure 3.17.5). The move did not represent significant tightening in view of large excess reserves held by the banking system. In March, however, the central bank raised its key lending and borrowing rates by 25 basis points. This action, ahead of its scheduled policy meeting in April, signaled a determination to begin shifting from a crisis mode toward a more neutral stance for monetary policy.

In announcing the change, the RBI cited several developments that prompted the need for a change in policy, including the positive trend in growth (due predominately to domestic factors), a sustained increase in demand for credit, a recent escalation in prices of nonfood manufactured

3.17.3 Growth of industrial production



Source: CEIC Data Company (accessed 21 March 2010).

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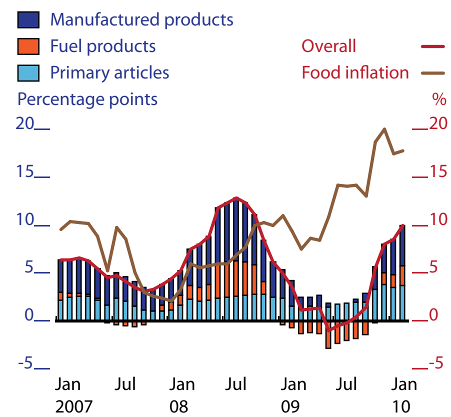
3.17.4 Contributions to inflation



Source: Ministry of Industry and Commerce. http://eaindustry.nic.in (accessed 15 March 2010).

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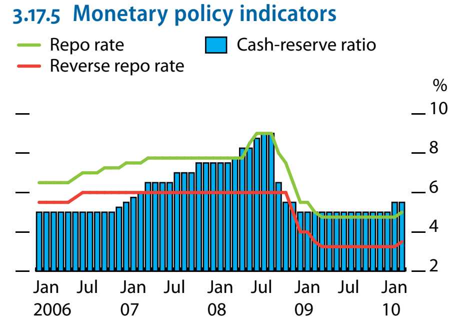
3.17.5 Monetary policy indicators



Source: CEIC Data Company (accessed 25 March 2010).

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goods, a need to keep inflation expectations in check, and lags inherent in the impact of monetary policy. While a shift in monetary policy is unlikely to affect food prices, timely policy adjustments in the months ahead can help underpin a return to India's past high growth rates while maintaining relative price stability.

In a sign of rebound, export growth turned positive in November 2009 after 13 months of year-on-year declines (Figure 3.17.6). An outlook survey on exports that was conducted by the Confederation of Indian Industry indicated that nearly half the respondents expected further volume growth in the coming months despite the rising cost of raw materials and stiff international competition.

The central government will continue for a time with the 2% interest subsidy on bank loans to certain sectors that are labor intensive, such as textiles, leather, handicrafts, cotton yarn, jute, minerals, and fruits and vegetables, which were particularly hard hit by the fall in global demand.

Imports moved to positive growth in December after 12 months of year-on-year contraction (Figures 3.17.7 and 3.17.8). Oil and non-oil imports slumped by about 25% and 17%, respectively, from April 2009 to January 2010, relative to the same prior-year period. Non-oil imports rose sharply from $12.4 billion in March 2009 to $16.9 billion in January 2010 on the strength of the domestic economic recovery.

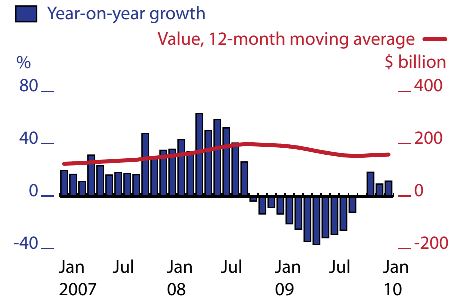
Although official balance-of-payments data for FY2009 are unavailable, various indicators suggest that the adverse effects of the global recession have largely played themselves out. Though reviving in the final months of FY2009, annual exports and imports are estimated to have declined by around 15% and 17%, respectively, yielding a moderate improvement in the trade deficit of about $24 billion (Figure 3.17.9). Net invisible receipts are estimated to have declined by $20 billion to around $70 billion, mainly due to a fall in miscellaneous business receipts. By these estimates, the current account deficit narrowed to 1.9% of GDP from 2.5% a year earlier.

A notable feature of economic revival was the resumption of large capital inflows, led by the turnaround in foreign institutional equity purchases from large net sales a year earlier, and a sustained high level of foreign direct investment. Total net capital inflows are estimated at $60 billion in FY2009 (up from $7 billion a year earlier), reflecting a return of risk appetite in global financial markets in conjunction with India's economic resilience as demonstrated over the course of the fiscal year. The capital account surplus more than covered the current account deficit.

Gross international reserves (including valuation adjustment) increased by about $25 billion to an estimated $280 billion by the end of FY2009 (Figure 3.17.10). The increase in reserves includes the allocation of SDR3.3 billion ($5.2 billion) made by the International Monetary Fund in August and September 2009. In November 2009, India purchased 200 tons of gold from that body, and this is reflected in the difference between gross international and foreign exchange reserves in the figure. Reserves are ample, amounting to about 13.1 months of imports of goods and services.

The rupee exchange rate appreciated both against the US dollar and

3.17.6 Export indicators



Source: CEIC Data Company (accessed 17 March 2010).

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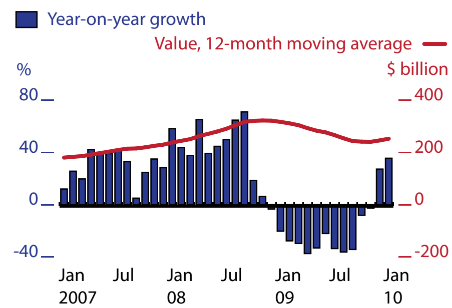
3.17.7 Import indicators



Source: CEIC Data Company (accessed 17 March 2010).

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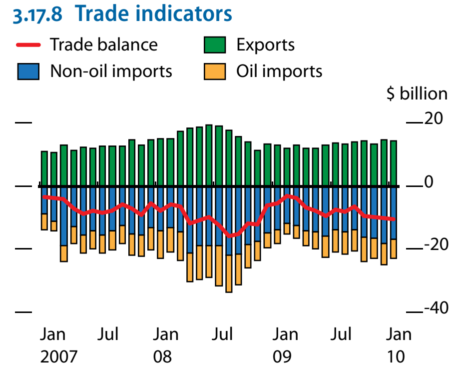
3.17.8 Trade indicators



Note: Total exports and imports based on customs data.

Source: CEIC Data Company (accessed 17 March 2010).

Click here for figure data

in real effective terms throughout FY2009 as the economy strengthened. This contrasts with a downward slide in FY2008 as the economy and balance of payments faltered. The real effective exchange rate appreciated by about 11% in FY2009, essentially reversing an equivalent depreciation in FY2008, though it remains about 6% below its mid-2007 high (Figure 3.17.11). The return of a large capital account surplus has required the RBI to resume interventions in the foreign exchange market to moderate abrupt upward pressure on the rupee and to support exports.

But given the rise in inflation and buildup of inflation expectations, the RBI may find it difficult to continue intervening. Among the first wave of economies leading the recovery phase, it may have to contend with managing even much larger capital inflows, which would put upward pressure on the exchange rate, interest rates, and growth of credit, replaying the difficult monetary policy mix of FY2007 when capital inflows surged. Thus, the central bank's effective use of sterilization and other capital control policies at the same time as it accepts some flexibility in the exchange rate will be critical in effectively managing the economy through its recovery phase.

The FY2009 budget of the central government was prepared in the midst of a marked slowdown in the domestic economy. It envisaged a substantial rise in government spending and maintenance of lower excise and service tax rates put in place in the latter part of the previous fiscal year as a main element of countercyclical policy measures. The outturn came very close to plans for both revenue and expenditure with the deficit at 6.7% of GDP (Figure 3.17.12).

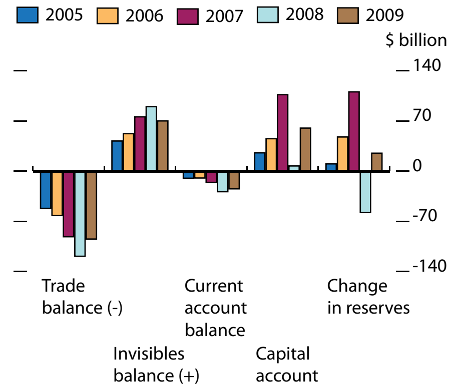
The consolidated general government deficit in FY2009, however, including off-budget liabilities for subsidies and the deficits of state governments, is expected to be about 10%. This, the second year of large deficits owing to the global crisis, had raised concerns over debt sustainability. In announcing the FY2009 budget the government pledged it would reduce the deficit to 5.5% of GDP in FY2010 and 4.0% in FY2011.

The central government budget for FY2010, introduced in February this year, was set against a somewhat more favorable background; the complex challenge of renewing the commitment for fiscal consolidation while sustaining rapid growth momentum. The central government reiterated its commitment to kick-start a well-coordinated exit strategy, and bring the budget deficit to 3.0% by FY2013.

This target was in line with the recommendations of the 13th Finance Commission fiscal road map that also called for the combined deficit of the states to fall to 2.4% of GDP in FY2013 and set a target for general government debt to be reduced to 68% of GDP by FY2014 (from 82% at end-FY2009). The introduction of a new direct tax code and a national goods and services tax effective from the start of FY2011 will underpin this fiscal effort.

The FY2010 budget deficit is set to decline to 5.5% of GDP, a 1.2 percentage point reduction. About one-half of fiscal consolidation is expected to be achieved through bigger revenue collection mainly due to faster growth, some retracement of the stimulus excise tax rate cut, a widening of the service tax net, divestment of stakes in state-run enterprises, and the sale of spectrum for third-generation telephony. On

3.17.9 Balance-of-payments indicators



Note: Change in reserves includes valuation adjustments.
Sources: CEIC Data Company (accessed 23 March 2010); ADB estimates.
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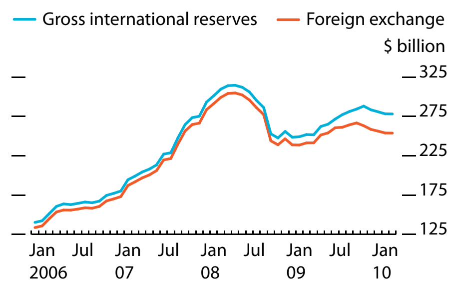
3.17.10 Reserves



Source: CEIC Data Company (accessed 17 March 2010).
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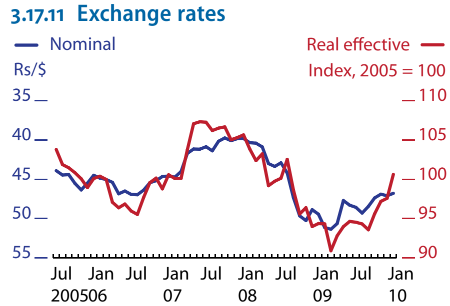
3.17.11 Exchange rates



Sources: Reserve Bank of India. http://www.rbi.org.in; Bank of International Settlements. http://www.bis.org (both accessed 17 March 2010).
Click here for figure data

the expenditure side, a reduction in the deficit of 0.6% of GDP is driven by a drop in current expenditure in relation to GDP.

The guiding principle of the budget on the expenditure side was to sustain high growth by boosting allocations for infrastructure while elsewhere ensuring that the benefits of high growth are broadly distributed. The budget took several steps in this direction. The allocation for the education and health sectors was raised by 16% and 14%, respectively, from FY2009 levels. The National Rural Employment Guarantee Scheme continued to get top priority with an allocation of Rs401 billion ($9 billion) in FY2010. The finance minister also reiterated that the government will address key issues in the areas of financial inclusion; rural and urban housing; social security for unorganized sector workers; women and child development; and micro, small, and medium-sized enterprises.

The budget began the exit from fiscal stimulus by partly rolling back the earlier rate reduction of 4 percentage points in central excise duties. It also raised the standard rate on all nonpetroleum products from 8% to 10%. Similarly, the ad valorem component of excise duty on large cars, multi-utility vehicles, and sports-utility vehicles, which was reduced as part of the stimulus package, was increased by 2 percentage points. Other tax proposals included rationalization of the income tax slabs; additional excise duty on petrol and diesel; and restoration of a 5% customs duty on petroleum products, including crude oil.

A landmark reform in the area of government subsidy is the introduction of nutrient-based subsidy for fertilizer. This policy is expected to improve agricultural productivity, contain the subsidy bill over time, and offer environmental benefits. Further, the government will no longer issue special off-budget bonds from FY2010 to finance subsidies for fuel, fertilizer and food; much-reduced programs are now to be supported on the budget.

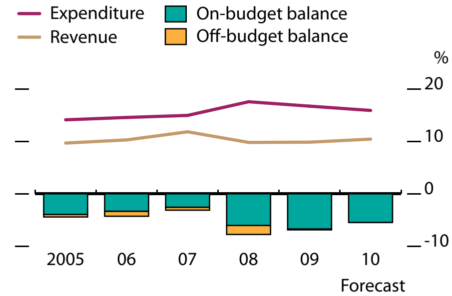
Another major fiscal development is a revived program for disinvestment of state-owned enterprises listed on the stock exchange by reducing ownership stakes (though not majority control). In FY2009, the government raised a record Rs335 billion (about $7 billion); the FY2010 budget calls for sales of Rs400 billion.

The Sensex, the main index of the Bombay Stock Exchange, witnessed a large runup in FY2009. This recovery, which began in March, was part of the general worldwide boom in stock prices set off by depressed valuations in conjunction with early signs of recovery in the global economy. A notable feature of the rally was the degree to which the increase in the Sensex exceeded a general index of emerging Asian stock markets: in the past, they have mostly moved in tandem (Figure 3.17.13).

Economic prospects

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

3.17.12 Central government fiscal indicators



Source: Ministry of Finance. http://indiabudget.nic.in (accessed 27 March 2010).
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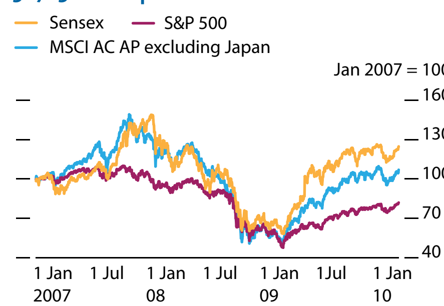
3.17.13 Stock price indexes



MSCI AC AP = Morgan Stanley Capital International All Country Asia Pacific.
Source: Bloomberg (accessed 17 March 2010).
Click here for figure data

3.17.1 Selected economic indicators (%)

	2010	2011
GDP growth	8.2	8.7
Inflation	5.0	5.5
Current account balance (share of GDP)	-1.5	-2.0

Source: ADB estimates.

expected in 2010 followed by further acceleration in 2011; and world trade will grow by 7%–8%.

Appropriate adaptations in monetary policy and the fiscal stimulus measures by the authorities and economic recovery in industrial economies will underpin the pace of growth in the forecast period. All recent surveys point to a marked improvement in business confidence. For example, the Dun & Bradstreet Composite Business Optimism Index for the first quarter of 2010 recorded an increase of 43% relative to the first quarter of 2009 (Figure 3.17.14). Moreover, six of seven "optimism subindexes" registered an increase from the previous quarter.

The HSBC Markit Purchasing Managers' Index for manufacturing for December 2009 recorded its highest level since May that year, suggesting a robust month-on-month improvement in manufacturing. The equivalent index for services also registered significant expansion, suggesting that the services sector, too, is well poised for a strong recovery.

Renewed investor and consumer confidence—the return of the exuberance that marked FY2005–FY2007, the years of 9% or more growth—is expected to fundamentally shape the outlook. Unlike FY2009, the composition of aggregate demand will be driven by strong advances in private consumption and investment in the next 2 years. Government consumption expenditure will cease to be an engine of growth.

The normalization of financial market conditions is expected to support a rebound of private investment, sustaining demand as the fiscal stimulus fades even with some hardening of lending rates. Major capacity enhancement plans in the cement, steel, aluminum, automobile, paper, tire, and electricity sectors are in the works. The return of ready access to global capital by Indian corporations will help bring these plans to fruition. The government's high priority for developing infrastructure is another factor in an investment-rich mix.

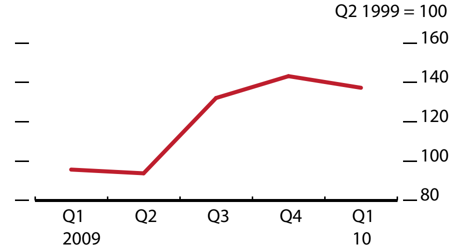
Urban consumption is expected to remain strong as the fear of large-scale job cuts has disappeared, substantial new hiring is under way, and salaries are back on a rising trend. The marked revival in the Sensex is also bolstering consumer and business attitudes. Expected normal rainfall and an enlarged National Rural Employment Guarantee Scheme will foster growth in rural consumption.

From the supply side, manufacturing and services will be the major drivers of expansion. Technology spending is expected to rebound in industrial countries, with their purchases set to post healthy growth, boosting growth in Indian high-tech services. These factors, in conjunction with recovery in the global economy, should lift GDP growth to 8.2% in FY2010 and 8.7% in FY2011 (Figure 3.17.15).

Inflation pressures are expected to ease in early FY2010 after the winter harvest. However, increases in the domestic prices of petrol, diesel, cooking gas, and kerosene are likely during the forecast period following the recommendations of the committee that rules on domestic fuel prices. While demand-pull inflation pressures in manufacturing are on the rise, the RBI has already begun an exit from monetary stimulus and is expected to keep price pressures in check. Thus inflation is forecast at 5.0% in FY2010 and 5.5% in FY2011 as international prices of oil and non-oil commodities edge up (Figure 3.17.16).

Large annual falls in exports and imports were recorded in FY2009,

3.17.14 D&B Composite Business 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: Dun & Bradstreet. 2010. *Business Optimism Index: India*. January. http://www.dnb.co.in

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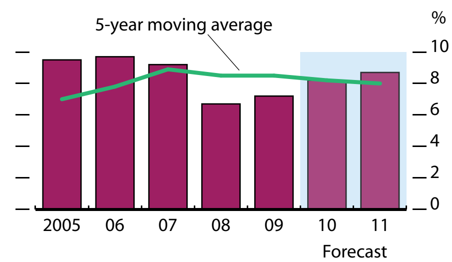
3.17.15 Annual GDP



Source: Asian Development Outlook database.

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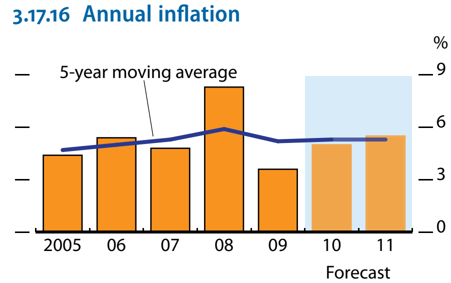
3.17.16 Annual inflation



Source: Asian Development Outlook database.

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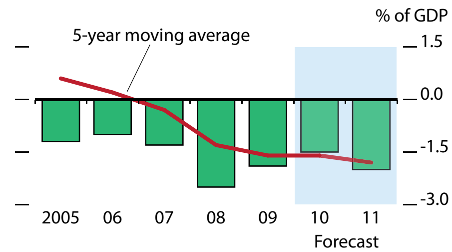
though growth moved into positive territory in the closing months of the year. Trade flows in FY2010 and FY2011 will climb, though at a slower pace than in years prior to the global slowdown. Exports are projected to gain 16.0% in FY2010 and 12.0% in FY2011. This would bring exports in FY2010 to near FY2008 levels and in FY2011 to just over the $200 billion target set in the government's foreign trade policy. These rates of expansion seem achievable given the expected revival in global trade volumes of 7.1% and 8.1% in these 2 years and the demonstrated focus and depth of India's export industries, exports of which grew at an annual average of nearly 24% in the 5 years through FY2008.

As GDP growth is pushed again to high levels and international oil prices firm, imports will expand rapidly, at 20.0% in FY2010 and 18.0% in FY2011. This projected expansion takes imports to 20%–21% of GDP and is in line with experience during FY2005–FY2007. The growing trade deficit is, however, expected to be partly offset by revival of growth in net invisibles from an expansion in the services surplus and an increase in transfers from nonresident Indians. Overall, the current account deficit is expected to widen marginally to 2.0% of GDP by FY2011 (Figure 3.17.17).

3.17.17 Current account balance



Source: Asian Development Outlook database.
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Development challenges

India is currently facing both short- and medium-term policy challenges. In the current situation, with its signs of economic recovery—albeit with uncertainties of how well entrenched growth is—policy makers face a dilemma. Too slow a removal of the fiscal stimulus may lead to a quick uptake of inflation and force them to raise interest rates by more than they would otherwise choose. Alternatively, too rapid a removal of monetary accommodation may lead the economy to stall and prolong the downturn.

Given the repeated occurrence of food price inflation in recent years, one of the major medium-term challenges of the central government is to design and implement a comprehensive plan for augmenting the domestic supply of food products, including vegetables and dairy products. The policy cannot be restricted to measures that enhance agricultural productivity. It needs to encompass many related issues including pricing, distribution, trade, subsidies, infrastructure, and research.

More specifically, one aim is to increase farmgate prices to trigger effective supply-side responses while containing retail prices, in order to mitigate erosion of purchasing power and adverse impacts on the poor. Since nearly half the food produced is lost from field to table, there is ample scope for solutions.

Finally, sustained acceleration in growth requires significant infrastructure building. Although much of the necessary investment will have to be privately funded, the government is tasked with substantially raising its own contribution. This is going to require real dexterity, especially at a time when its priority is to contain the fiscal deficit. It can release additional funding for infrastructure spending by containing subsidies as part of the consolidation of current expenditure and by promoting alternative sources of investment financing, such as public–private partnerships.