India

Developments are challenging India's strong growth performance of recent years. Emerging capacity constraints, continued rapid expansion in credit, and partial pass-through of global commodity price increases have triggered steep domestic inflation and consequent monetary tightening. A widening trade deficit, moderating capital inflows, and some depreciation in the rupee are also current features. The main problem, however, consists of the large fiscal imbalances that have been created by escalation in oil and other subsidies and by other unbudgeted liabilities. How well the Government can address this difficult issue, so as to maintain macroeconomic stability, and move on to adopt needed structural reforms is key to fulfilling the country's enormous potential.

Updated assessment

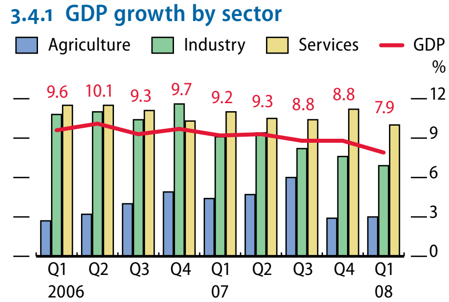
With 9.0% expansion in FY2007 (which closed at end-March 2008), India marked its fifth successive year of robust growth, even against a backdrop of growing turmoil in international financial markets and price escalation in commodities. An impressive 4.5% increase in agricultural production propped up the performance. Industry and services growth, though, decelerated. Since the start of FY2008, a combination of various domestic and international factors that have set off steep domestic inflation and the resultant measures to rein it in is slowing the pace of expansion.

These factors include the marked international price increases in oil, food, and metals, worsening fiscal and current account deficits, increasing cost of funds, moderating capital inflows, some depreciation in the rupee against the dollar, and decelerating growth in industrial economies. The Indian economy is now at a critical juncture where policies to contain inflation and ensure macroeconomic stabilization have taken center stage.

In the first quarter of FY2008 (April–June), GDP growth decelerated to 7.9% from 9.2% in the corresponding prior-year quarter (Figure 3.4.1), for the slowest expansion in three and a half years. The most pronounced slide was in industry where growth fell to 6.9%, dragged down by a halving in the manufacturing growth rate (to 5.6%). The slowdown was broad-based with agriculture and services sector growth coming in at 1.4 and 0.9 percentage points, respectively, below their expansions of the year-earlier quarter.

While growth in consumption expenditure held steady in the first quarter of FY2008, expansion in fixed investment fell to 9.0% from 13.3%, as higher interest rates and a weakening global and domestic outlook appear to be causing companies to scale back investment. Industrial production data available through June confirm a general slowdown, which is most pronounced in basic, intermediate, and capital goods production (Figure 3.4.2). This indicates that investment—which has

3.4.1 GDP growth by sector



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 29 August 2008.

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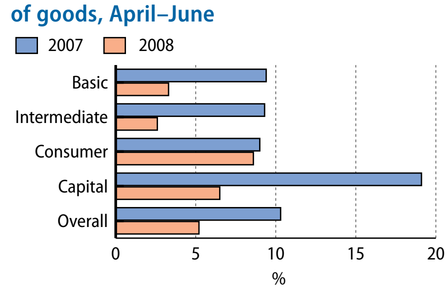
3.4.2 Industrial production growth by type of goods, April–June



Source: CEIC Data Company Ltd., downloaded 19 August 2008.

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This chapter was written by Shikha Jha of the Economics and Research Department, ADB, Manila; and Hiranya Mukhopadhyay of the India Resident Mission, ADB, New Delhi.

accounted for much of GDP growth in recent years (Figure 3.4.3), rising to about 34% of GDP in FY2007—is slackening. Growth of consumer nondurable goods also contracted, but consumer durable goods production, hard hit a year ago, improved on account of strong rural demand.

A survey of manufacturing companies, carried out in June 2008 by the Reserve Bank of India (RBI), indicates a moderation in business optimism. Surveys of industry confidence by other bodies convey a similar picture. This is corroborated by the composite business optimism index for July–September 2008 prepared by Dun and Bradstreet, which shows a decline of 11.2% against the previous quarter and by 18% against the previous year. Further indicators of a weaker economic outlook are found in a credit rating change by Fitch. In July, it confirmed its BBB- rating on foreign currency debt but downgraded the outlook for India's long-term local currency debt from stable to negative, noting a deterioration in the fiscal position.

Inflation based on the wholesale price index (WPI) began to gradually rise from December 2007 (Figure 3.4.4). It surged in the first 5 months of FY2008 to touch a 16-year high of 12.6% in early August but slipped back to 12.4% by mid-August. The steep rise was largely due to a hardening of prices of primary articles and manufactured products. Food inflation has picked up (by about 2 percentage points in the first 5 months of FY2008), reaching 9.8% year on year in mid-August.

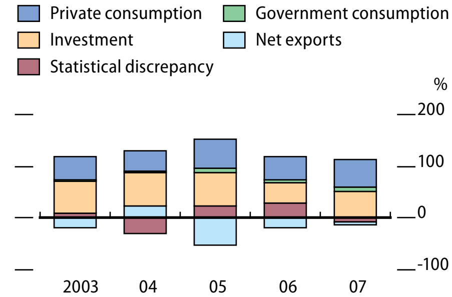
The Government sought to limit price pressures by (in addition to monetary policy tightening) various ad hoc interventions, including reduction in customs duties on certain basic food items, steel, crude oil, and oil products. It also banned the export of wheat, non-basmati rice, and pulses, and imposed export duties on some steel products.

RBI has adjusted key policy instruments to contain inflation pressures in FY2008 (Figure 3.4.5). These included several rounds of raising the cash-reserve ratio (taking it to 9.0% from 30 August) and putting up the key policy rate (the repo rate, the rate at which banks borrow from RBI). It lifted this rate to 9.0% on July 29. It kept the reverse repo rate (the rate at which banks park their surplus funds with RBI) unchanged at 6.0%.

Monetary policy has maintained prime lending rates at above 12.0% since January 2007 (Figure 3.4.6) when inflation previously breached RBI's tolerance level, even though inflation subsequently subsided. At end-August 2008, prime lending rate quotes were 12.75–13.25%. Lending rates for nonprime borrowers were in the range of 15–17%. Actions to date have not, however, markedly reduced credit expansion or arrested the rise in prices. One reason for this, as seen in Figure 3.4.6, is that real interest rates have fallen.

Bank credit to the commercial sector has been rising in FY2008, with year-on-year growth climbing to 26.8% at end-July from 22.3% at end-March (Figure 3.4.7). High demand for working capital by the state-owned oil-marketing companies and bank loans to fill in for diminished foreign funding seem to be two important reasons for the ongoing credit expansion. While data on FY2008 foreign borrowing are not yet available, the cost of credit default swaps on prime Indian companies is an indicator of risk aversion and tight access for most domestic companies (Figure 3.4.8).

3.4.3 Contributions to GDP growth (demand)



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 29 August 2008.

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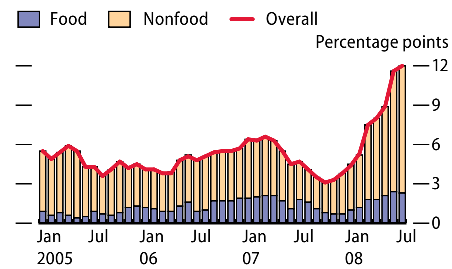
3.4.4 Contributions to wholesale price inflation



Source: CEIC Data Company Ltd., downloaded 3 September 2008.

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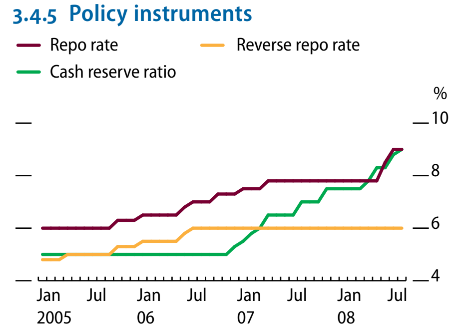
3.4.5 Policy instruments



Source: CEIC Data Company Ltd., downloaded 3 September 2008.

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The limited pass-through of international prices to the domestic market in recent years (Figure 3.4.9) has kept fuel prices artificially low. It has repressed inflation, but also fostered demand pressures and created off-budget liabilities. Special bond issues to compensate state-owned oil-marketing companies for selling below cost—“underrecoveries”—in FY2007 amounted to Rs212.5 billion, or 0.5% of GDP. (These bond issues, however, cover only part of the losses; the companies must absorb the balance.) As the average price of the Indian crude basket shot up to $130 per barrel in June 2008, domestic fuel prices were raised by about 10% to limit fast-growing losses. Private oil-marketing companies are not compensated for their losses stemming from price competition with the state companies, leading to some closures in their marketing operations.

As indicated in Figure 3.4.10, the combined budget deficits of the central and state governments have been substantially reduced over the past 5 years, reflecting the governments’ efforts to adhere to fiscal responsibility legislation. For FY2008, the central Government’s deficit is budgeted at 2.5% of GDP and the states’ at 2.1% (4.6% of GDP on a consolidated basis). A wider tax base, supported by a buoyant economy, and improved compliance have been the major factors underpinning the appreciable fiscal consolidation.

Two main challenges must be overcome before the FY2008 deficit targets can be met: a slowing economy that may limit the revenue buoyancy seen in recent years and spending pressures resulting from the central Government’s decision to raise the salaries of its employees by 21% (at a cost of $3.6 billion, or about 0.3% of GDP) in response to recommendations of the Sixth Central Pay Commission. About half a dozen states immediately announced similar wage rises and others are following suit. Provision for these salary increases was not budgeted.

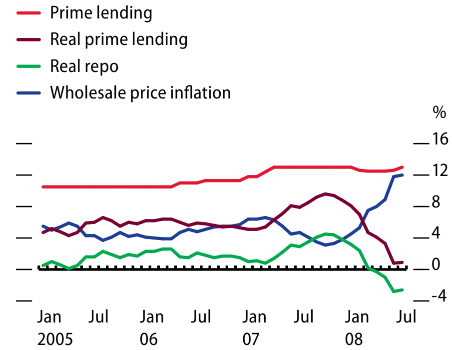
The major fiscal issue for FY2008 is the expected magnitude of off-budget subsidy items, which undermines fiscal consolidation. The Economic Outlook for FY2008 prepared by the Economic Advisory Council to the Prime Minister calculated that at a crude oil price of $130 per barrel, after taking into account the June price increase, and apportioning some contribution from oil production companies, the Government would need to issue oil bonds to marketing companies equivalent to 2.2% of GDP (about Rs1.2 trillion).

The Economic Outlook also calculated that at prevailing import prices the budgeted fertilizer subsidy underestimated costs, and bonds amounting to 1.2% of GDP (Rs645 billion) would need to be issued. A similar calculation for the food subsidy showed that a bond issue of 0.8% of GDP would be required.

In addition, the debt-waiver program to qualifying farmers announced in the March 2008 budget speech is also funded off-budget by bond issues (to the creditor banks). Its cost is estimated at Rs717 billion, about 1.3% of GDP. Accordingly, off-budget obligations of the central Government in FY2008 are likely to be around 5.5% of GDP, bringing a comprehensive estimate of its expected deficit to about 8% of GDP and the consolidated (central and state) deficit to be around 10% of GDP. (This excludes the perennial large operating losses of state-government electricity corporations.)

Since the bond issues for oil-marketing companies and for fertilizer

3.4.6 Wholesale price inflation and interest rates



Source: CEIC Data Company Ltd., downloaded 3 September 2008.

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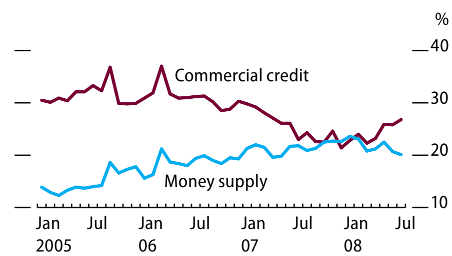
3.4.7 Growth in monetary indicators



Sources: CEIC Data Company Ltd.; Reserve Bank of India, *Weekly Statistical Supplement*, 15 August 2008, available: www.rbi.org; both downloaded 3 September 2008.

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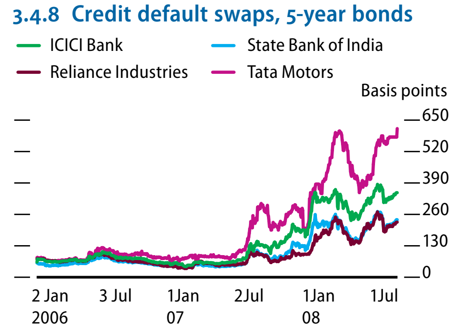
3.4.8 Credit default swaps, 5-year bonds



Source: Datastream, downloaded 3 September 2008.

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and food corporations of 4.2% of GDP will need to be sold (to allow these companies to continue operating), their size is likely to create monetary pressures. A rough indicator of the problem may be seen in the fact that private bank credit expansion in FY2007 was the equivalent of about 10% of GDP. Thus, the addition to credit demand from such large bond issues will likely push up interest rates, crowd out investment, and add to inflation pressures—unless monetary policy is tightened sufficiently. The interest paid on the bonds will also add to fiscal pressures.

The farm-debt waiver raises different issues, in that the bonds will be issued to replace other assets (farm loans). The main problem seems to relate to moral hazard—will farmers' credit discipline to service new credits taken out for farm operations be heavily eroded? And if so, will banks react by adjusting credit standards and loan limits in a way that worsens farm production? Since the waiver program does not cover farmers' debts to money lenders, the waiver may not benefit much the very poorest farmers who depend heavily on these lenders, thereby resulting in a more limited supply response than intended, and a diminished humanitarian effect.

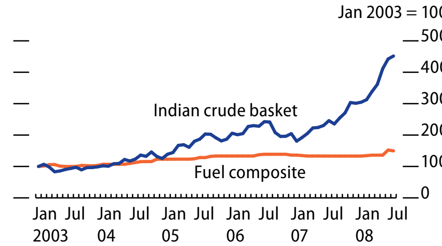
The trade and current account deficits have widened in recent years (Figure 3.4.11), reflecting primarily the impact of escalating oil prices and the expansion in non-oil imports, led by rapid growth in consumer and investment demand. In FY2007, merchandise import growth of 29.9% was considerably faster than export growth of 23.7%; the trade deficit widened to $90 billion (7.7% of GDP). The current account deficit was, however, contained at $17.4 billion, or 1.5% of GDP, by the country's healthy invisibles balance that stems mainly from exports by its successful software and business services industry. The capital account surplus, on a rising trend, surged to $108 billion in FY2007, largely reflecting net foreign investment, including nearly $30 billion of portfolio investment as well as heavy commercial borrowing by Indian companies (Figure 3.4.12).

Balance-of-payments data for FY2008 are not yet available. Customs data indicate that the trade deficit further widened to $41.2 billion in the first 4 months of FY2008 as against $27.4 billion in the same period a year earlier. Exports continued to expand rapidly, by 24.6%, as did imports, at 34.2%. Oil imports increased by 54.9% to $35.0 billion, and accounted for nearly 35% of total imports (Figure 3.4.13). Non-oil imports rose by 25.2% to $65.4 billion, at a slower pace than in FY2007, reflecting decelerating economic activity in the first 4 months of FY2008.

Little information is available on developments in the capital account for FY2008. Portfolio investment recorded net outflows in April–July 2008 while direct investment increased. Nevertheless, it is apparent that net capital inflows are on an appreciably lower track than a year ago as foreign exchange reserves have fallen by $13 billion in the first 5 months of FY2008 (through end-August), explained in part by valuation losses, compared with a $30 billion gain in the corresponding year-earlier period. This drop in reserves indicates that capital flows were insufficient to cover the current account deficit.

Foreign exchange reserves swelled to $300 billion at end-March 2008 (Figure 3.4.14), though they fell slightly through end-August. The accumulated reserves of over 20% of the fiscal year's estimated GDP provide a very generous cushion against external vulnerabilities.

3.4.9 Oil and fuel price indexes



Sources: Datastream; CEIC Data Company Ltd.; both downloaded 3 September 2008.

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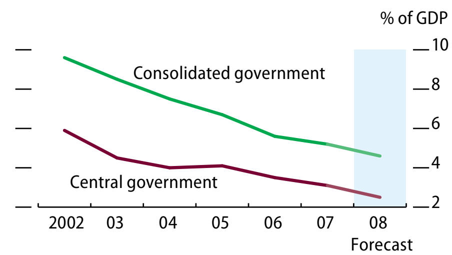
3.4.10 Gross fiscal deficit



Source: Reserve Bank of India, *Macroeconomic and Monetary Developments: First Quarter Review 2008–09*, available: www.rbi.org, downloaded 3 September 2008.

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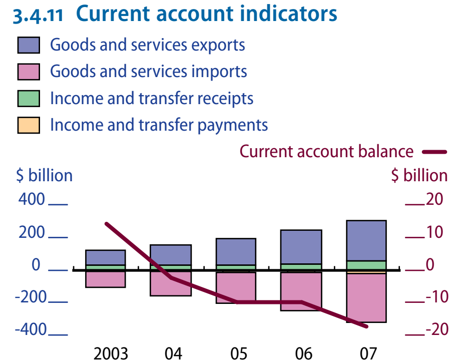
3.4.11 Current account indicators



Source: CEIC Data Company Ltd., downloaded 22 August 2008.

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The rupee–US dollar exchange rate appreciated in the first quarter of FY2007, and then kept relatively steady over the rest of the fiscal year. The rate depreciated by 8.7% in the first 5 months of FY2008 (Figure 3.4.15). At end-August, it had fallen to Rs43.79/$1, reflecting the toll of rising inflation, weakening capital inflows, and a growing current account deficit. While a weakening rupee exacerbates inflation pressures, it benefits exporters. In real effective exchange rate terms, FY2007's rupee appreciation had been offset by the end of the first quarter of FY2008.

The main index of the Bombay Stock Exchange, the Sensex, was down by about 30% from its 8 January 2008 all-time high at end-August. This drop follows, however, a very steep runup in stock prices over recent years. As indicated in Figure 3.4.16, the decline in the Sensex is broadly in line with the performance of other Asian emerging markets. Indeed, data from early July show some relative strengthening in the Indian market despite the country's emerging economic difficulties. It appears that the tumbling stock market in India, as elsewhere in Asia, largely reflects a general caution by both domestic and foreign investors toward the continued turmoil in global financial markets, and toward slowing economic growth and rising inflation both globally and in most Asian countries.

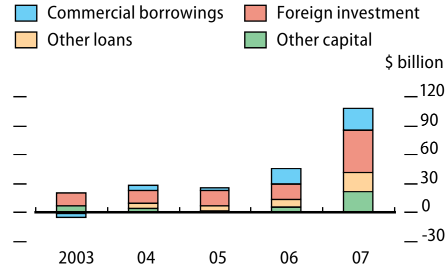
Prospects

The forecasts made by *Asian Development Outlook 2008* (*ADO 2008*) for FY2008 and FY2009, released in April this year, were based on assumptions that are substantially revised in this *Update*. Marked changes in the *ADO 2008* baseline assumptions for increases in global oil and nonfuel commodity prices, as well as the degree of slowdown in industrial-country GDP growth, now suggest a much less conducive environment for growth and price stability (see Table 1.1.1 in Part 1). Moreover, the extent and duration of the global credit market turmoil and its impact on India's access to external finance were not foreseen in April.

Changes in domestic assumptions now include: (i) RBI will need to further tighten its monetary policy stance in FY2008 and then maintain this tight policy in FY2009; (ii) further upward revisions to domestic prices of gasoline and diesel, which were increased in June, will probably only be put through in FY2009 (that is, after the parliamentary elections to be held by May 2009); (iii) the rupee–US dollar exchange rate will likely depreciate but only to offset any appreciation in the real effective exchange rate; and (iv) the food supply situation will broadly be comfortable, because food grain stocks have been rebuilt and because the monsoon is expected to be normal, implying trend growth in agricultural output in FY2008.

The change in the global economic environment and the policy adjustments needed to maintain macroeconomic stability prompt a downward revision of the growth forecast to 7.4% in FY2008 and to 7.0% in FY2009. Taking account of the monetary tightening already undertaken, which will likely be supplemented by further measures later in the year, inflation is expected to remain high partly owing to the pass-through of the June increase in oil product prices before coming down to 9.0% in March 2009. WPI inflation would average 11.5% in FY2008. For FY2009, a

3.4.12 Capital account components



Source: CEIC Data Company Ltd., downloaded 3 September 2008.

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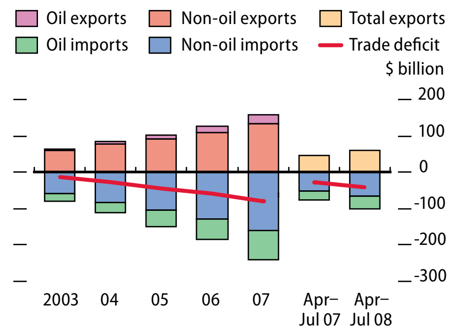
3.4.13 Trade indicators



Sources: Reserve Bank of India, *Handbook of Statistics on Indian Economy* and *RBI Bulletin*, available: www.rbi.org; CEIC Data Company Ltd.; all downloaded 3 September 2008.

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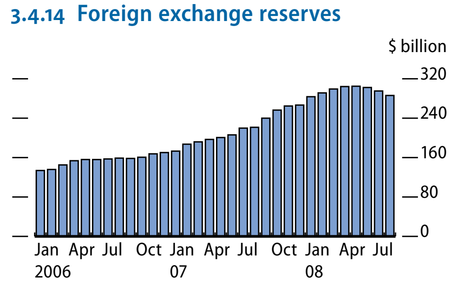
3.4.14 Foreign exchange reserves



Sources: CEIC Data Company Ltd.; Reserve Bank of India, *Weekly Statistical Supplement*, various issues; all downloaded 5 September 2008.

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revised inflation forecast is penciled in at 7.5%, including the impact of a substantial but not comprehensive upward adjustment in oil prices.

While most developing Asian countries now face the burden of adjusting to the same, grimmer circumstances, India's very large fiscal imbalance created by the current level of subsidization of oil, fertilizer, and food, as well as other off-budget items, sets a daunting task for economic management. Cutting these subsidies is a difficult task, but maintaining them would imperil any return to the high-growth path of recent years.

The main adjustment to the revised growth forecast stems from a weakened investment outlook. Negative factors include increasing caution by businesses because of faltering confidence in the near-term economic outlook, fewer options for foreign financing in all forms—commercial borrowing, initial public offerings of shares, and bonds—owing to a drop in risk appetite by foreign financial institutions, growing difficulties in securing domestic bank financing because of crowding out by government bond issues, and the need to maintain tight monetary conditions and high interest rates to bring down inflation. These circumstances are now expected to prevail well into FY2009, and will continue to limit growth in investment, which in turn will cause GDP growth to edge down to 7.0%.

RBI faces a serious dilemma in its monetary management policy. On the one hand, further increases in short-term policy rates or the cash-reserve ratio could threaten growth objectives. On the other, inflation is still way beyond its stated 7.0% policy objective to be achieved by end-March 2009. Financing the current level of subsidies will increase the pressure for rapid credit expansion in the year which, unless checked, will lead to higher inflation. Thus, a further tightening in policy, raising both nominal and real interest rates, will probably be required. High interest rates are likely to run on to FY2009 to keep inflation in check as administered prices are rationalized. A full adjustment would likely see inflation come in higher than the *Update* forecast. Though unlikely, such an adjustment would help bring forward a revival in investment.

High oil prices are the major contributor to trade and current account deficits, wider than forecast in April; growth in exports of software services is also assumed to ease. The current account deficit forecast for FY2008 is expanded to a deficit of $41 billion, or 3.1% of GDP, from *ADO 2008's* 2.2% deficit. Similarly, a current account deficit of $51 billion, or 3.6% of GDP, is forecast for FY2009 (against 2.6% previously).

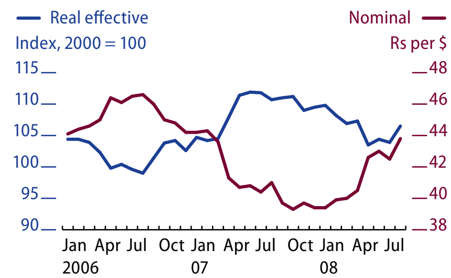
The key risks to the above outlook emerge from the following: the persistence of high oil and food prices and the difficulty in finding a consensus to adopt policies that shift government resources from broad subsidization to more focused interventions to assist the poor; the threat of a wage-price spiral (if inflation is not checked); and the long-term impact on growth of failure to adopt the structural measures needed to take the country back to its formerly impressive growth path.

3.4.1 Selected economic indicators (%)

	2008		2009	
	ADO 2008	*Update*	*ADO 2008*	*Update*
GDP growth	8.0	7.4	8.5	7.0
Wholesale price inflation	4.5	11.5	5.0	7.5
Current acct. bal. (share of GDP)	-2.2	-3.1	-2.6	-3.6

Source: Staff estimates.

3.4.15 Exchange rates



Sources: CEIC Data Company Ltd.; Bank for International Settlements, available: www.bis.org; both downloaded 22 August 2008.

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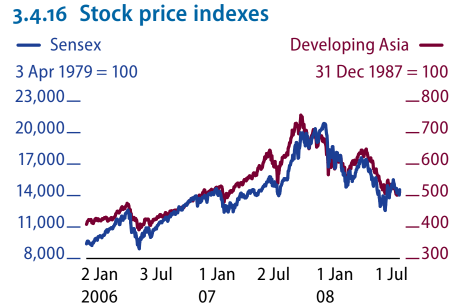
3.4.16 Stock price indexes



Note: The index for developing Asia is represented by the Morgan Stanley Capital International All Country Asia excluding Japan price index.

Source: Datastream, downloaded 2 September 2008.

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