India

Tight monetary policy to cool overheating slowed growth, but India remained among the fastest growing of the world's major economies. Though largely driven by domestic demand, the country is nevertheless vulnerable to the worsening global economic environment. Avoiding a deep downdraft in the next 2 years will primarily be shaped by the outcomes of three counteracting forces: keeping food price inflation moderate, lowering interest rates to sustain high levels of investment, and containing the fiscal deficit. The country's dynamism in recent years underpins the high growth path. Key structural challenges include establishing a new fiscal adjustment road map, raising labor productivity, and enhancing structural reforms.

Economic performance

The impressive economic performance of the past few years continued, though growth slowed from 9.6% in FY2006 to 8.7% in FY2007 (ended March 2008) according to the official advance estimate (Figure 3.17.1). The deceleration, reflecting tightened monetary policies, touched all sectors (Figure 3.17.2). Industry, contributing about 29% of GDP—and a major driver of growth in FY2006—eased a little. The key factors were weaker growth in consumer spending, pinched by inflation pressure and higher borrowing costs. The slowdown was led primarily by a decline in consumer durables production, but other manufacturing industries as well as mining and energy (oil, coal, and electricity) also made weaker contributions (Figure 3.17.3). The trend prompted the Government to set up a high-powered committee to examine measures to sustain manufacturing growth over the next decade, with a focus on labor-intensive manufacturing exports such as textiles, leather, and handicrafts.

Agriculture, accounting for about 18% of GDP, saw a sharp drop in growth from 3.8% in FY2006 to 2.6% in FY2007. The reduction came mainly from a poor winter crop. The low growth rate also reflected underlying structural weaknesses stemming from falling levels of public investment and steady deterioration in public institutions that provide credit, inputs, and research and extension services. A "technology fatigue" has emerged, as the benefits from the Green Revolution of the 1960s and 1970s have waned. Yields of new crop varieties have reached a plateau and remain substantially lower both than yields in major producing countries and than potential yields possible with best cultivation practices. For instance, average wheat and rice yields in India's bigger states are about 25–50% lower than those achieved in experimental stations.

In response to falling agricultural growth, the Government has set a goal of doubling growth from 2% a year over the last decade to 4% in the 11th Five-Year Plan (2007–2012) by bridging the gap between potential and

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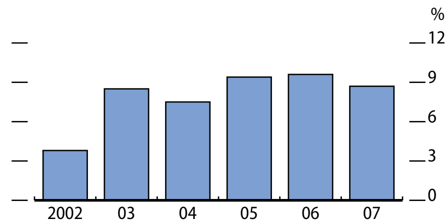
3.17.1 GDP growth



Source: Central Statistical Organisation, available: www.mospi.nic.in/cso.htm, downloaded 24 March 2008.
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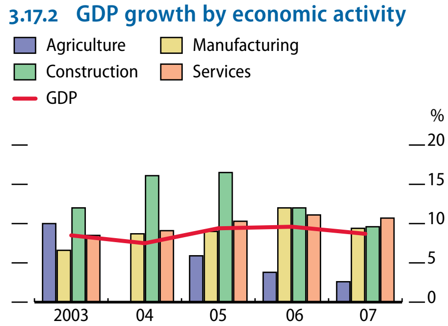
3.17.2 GDP growth by economic activity



Source: Central Statistical Organisation, available: www.mospi.nic.in/cso.htm, downloaded 24 March 2008.
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actual yields. To improve credit availability to farmers, it is also providing Rs9 billion capital to strengthen 27 regional rural banks in 15 states.

The key contributor to growth is services, which generated about 53% of GDP and continued its rapid growth, at 10.7% in FY2007. It was led by the trade, hotel, transport, and communications subsector. The financing, insurance, real estate, and business services subsector remained healthy despite a decline in growth. Booming construction in particular took a hit, decelerating from 12% in FY2006 to 9.6% in FY2007 as a result of hardening lending rates and tightening prudential policies by the Reserve Bank of India (RBI), intended to avoid excessive credit expansion in what had been a growing speculative real estate market.

Growth in the economy is essentially driven by domestic demand, which remains strong despite rising inflation (Figure 3.17.4). Robust growth in real wages and remittances buttressed consumption. The growth rate of private final consumption expenditure fell marginally from 7.1% in FY2006 to 6.8% in FY2007. Demand for consumer durables, such as automobiles, motorcycles, and scooters, was particularly affected by the rising costs of borrowing. Government consumption spending also fell, from 6.2% in FY2006 to 5.5% in FY2007, in keeping with rationalization of expenditure and deficit commitments made under the Fiscal Responsibility and Budget Management Act of 2003.

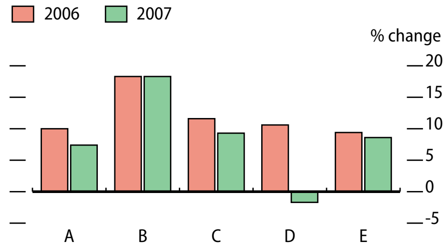
Investment was the fastest-growing component of domestic demand. The pace of gross fixed capital formation in FY2007 rose to 15.7%. Capital inflows, bank credit, reinvestment of profits, robust business confidence, and high capacity utilization bolstered private investment. Buoyant corporate profits in recent years allowed a large part of firms' investment to be financed from internal resources. Growth in bank credit to commercial enterprises subsided in the second half of FY2007 (Figure 3.17.5). However, the surge in capital inflows continued unabated on account of economic performance, healthy productivity growth, tightening financial integration with world markets, and a wide interest rate differential relative to the rest of the world.

RBI has been attempting to control money supply growth to maintain price stability, while seeking to ensure credit market and interest rate conditions that support investment in the context of relative stability in the exchange rate. But it has had limited success. The year-on-year money supply growth of 24% (to end-January) remains significantly higher than the target growth rate of 17–17.5% (Figure 3.17.6). Strong capital inflows have increased money supply, raising inflation pressure and rendering difficult the management of monetary and exchange rate policy.

In FY2007, RBI followed a dual-policy approach to allow greater exchange rate flexibility along with intervention in the foreign exchange market. This led to appreciation of the rupee against the United States (US) dollar (Figure 3.17.7), mainly in the early months of the fiscal year, and a large accumulation in RBI's foreign exchange assets over the full year. While the rupee weakened slightly in the latter part of FY2007, it appreciated by about 13% against the US dollar and by about 7% on average for the year in real effective terms.

Acknowledging the risk of excess liquidity at banks leading to resurgent inflation pressure, RBI has raised the cash-reserve ratio several times since late 2006, with the latest move (of 50 basis points)

3.17.3 Use-based industrial production



A = basic goods; B = capital goods; C = intermediate goods; D = consumer durables; E = consumer nondurables.

Note: Data refer to April–January of fiscal year.

Source: Central Statistical Organisation, available: www.mospi.nic.in/cso.htm, downloaded 24 March 2008.

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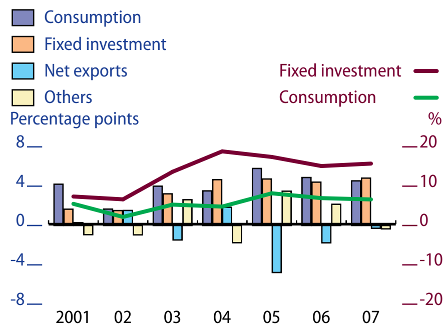
3.17.4 Contributions to growth and growth rates (demand)



Source: Central Statistical Organisation, available: www.mospi.nic.in/cso.htm, downloaded 24 March 2008.

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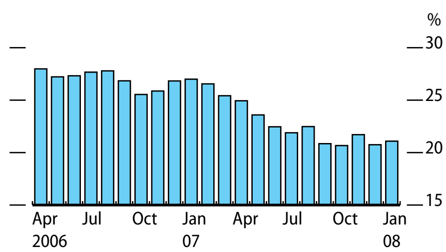
3.17.5 Growth of bank credit to the commercial sector



Source: CEIC Data Company Ltd., downloaded 12 March 2008.

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in November 2007, bringing the ratio to 7.5%. Concerns about inflation expectations have also led it to keep its key policy interest rate (the repurchase rate) unchanged at 7.75% in recent months. However, the steep and unexpectedly large cuts in US interest rates in early 2008 have created a much larger differential with Indian lending rates, which are among the highest in Asia. The pressure is mounting on RBI to cut its rates even though high inflation means that there is no room for easing its policy.

The tight monetary stance brought down inflation in manufactured goods but after October this was outweighed by rising food and energy prices. Inflation, as measured by year-on-year growth in the wholesale price index, reached 4.6% in February 2008 (Figure 3.17.8), creeping toward RBI's target limit of 5%. In early March 2008, the first of the monthly readings on inflation jumped to 5.9%, a 10-month high, driven by further food price increases.

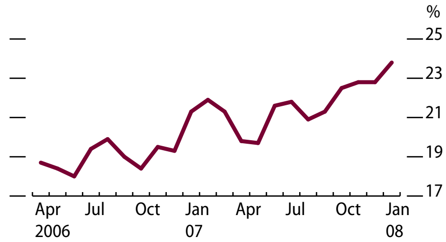
The federal Government has made partial upward adjustments (averaging 4.4%) in the retail prices of gasoline and diesel in FY2007 to accommodate increasing global prices, while keeping unchanged the prices of kerosene and liquefied petroleum gas, mostly used by lower-income groups. Figure 3.17.9 presents the rising discrepancy between the price India pays to import its fuel basket and the domestic composite price index of fuels—the above two fuels plus gasoline and high-speed diesel oil. The difference between ex-refinery costs and domestic selling prices ("underrecoveries") of state-owned oil marketing companies has been offset through payments of oil bonds issued by the Government. Gross underrecoveries of these companies, an off-budget item, are estimated to be Rs718 billion in FY2007 (approximately 1.5% of FY2007 GDP).

World prices of foodgrains and edible oils have risen sharply owing to severe supply shortages and dwindling inventories. Some development agencies project that global food prices by 2017 could be 20–40% higher than the average of 2002–2006. India has emerged as the largest importer of edible oils in the world with more than 40% of its domestic demand met through imports. Reflecting the tight global situation and affected by domestic supply constraints, food prices have risen faster than overall inflation in recent months. The Government has responded by increasing subsidies on food items, controlling exports, and subsidizing imports.

Supporting the widening gap between world and domestic prices of food and fuel in the face of compelling spending pressures at the same time as meeting fiscal deficit targets has involved a delicate balance that cannot be kept indefinitely. This was acknowledged in the FY2008 budget speech when the finance minister indicated that he intended to ask the 13th Finance Commission to provide a revised road map for fiscal adjustment, which would take into account off-budget subsidies on oil, food, and fertilizer (which have been funded by bond issues).

Appreciation of the local currency against the US dollar has hurt Indian exporters. Merchandise exports (on a customs basis) grew by 21.6% in the first 10 months of FY2007 when expressed in US dollars (Figure 3.17.10). However, this reflects the sharp appreciation of the rupee more than the actual increase in exports, the growth of which, in rupee terms, was subdued at just 7.7%. The slowdown was evident most notably in chemicals, engineering goods, textiles, and readymade garments and handicrafts.

3.17.6 Growth of money supply



Source: CEIC Data Company Ltd., downloaded 12 March 2008.

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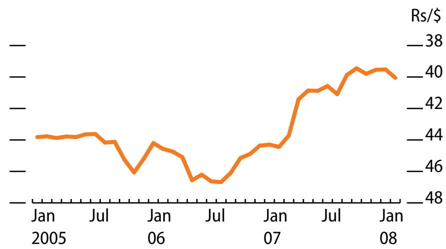
3.17.7 Nominal exchange rate



Source: CEIC Data Company Ltd., downloaded 24 March 2008.

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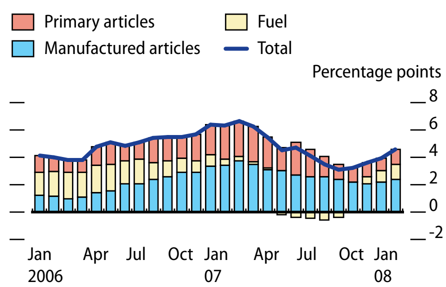
3.17.8 Contributions to wholesale price inflation



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 11 March 2008.

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The growth of merchandise imports, at 29.6% in US dollar terms in the first 10 months of FY2007, is also overstated when compared to its rupee value (14.7%). Non-oil imports of capital goods, chemicals, edible oils, and precious and semiprecious stones provided the main stimulus for import growth, rising by 36.1%, while oil imports advanced by 16.5%. The net effect was a near 50% widening of the US dollar trade deficit from a year earlier.

Official estimates of the balance of payments for FY2007 are unavailable; however, preliminary estimates indicate that the current account deficit will be about 1.9% of GDP, higher than the 1.1% in FY2006. Although the trade deficit widened significantly, it was offset by a strong rise in the inflow of remittances and a growing surplus from exports of services such as software and business services, though their expansion in earnings was reduced from the rapid rates seen in previous years.

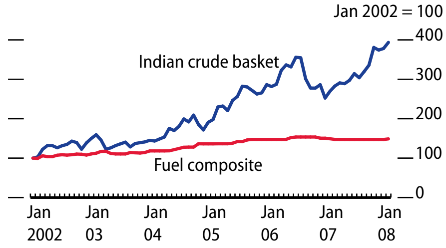
RBI's foreign exchange reserves (including valuation adjustments) saw a $105 billion surge (through mid-March 2008) to $296.5 billion (Figure 3.17.11). This indicates that the capital account surplus in FY2007 has apparently doubled in a year, primarily because of a large rise in net portfolio investment and continued large net inflows from commercial borrowing, short-term credit, and other capital.

RBI interventions in the foreign exchange market brought greater stability and a slight weakening in the currency in the latter part of FY2007. Measures are being implemented to cushion the impact of the exchange rate appreciation on exporters. These include interest subsidy on export credit, increases in duty drawback rates, refund of tax charged on services related to exporting, and lower customs duty on some raw materials for textiles. Some of these measures are ad hoc and may be difficult to sustain if the rupee continues to appreciate.

The stock market kept up its 3-year bull run in FY2007 (Figure 3.17.12), which featured a substantial increase in portfolio investment by foreign institutional investors, though they remain relatively small players (owning roughly 5% of market capitalization but accounting for about 15–20% of the trading). However, the Sensex has shown increased volatility since early January 2008 and the market has fallen by about 25% through 24 March from end-December. The downturn broadly mirrors the same anxieties (caused by the global financial market turmoil and fears of recession) that have been seen in most markets elsewhere. Still, the Indian market was up by about 15% over the year to 24 March. Since valuations in India are high, priced on the assumption of continued rapid corporate growth, a deep and prolonged slide in the market would likely undermine business confidence and add to downward pressures in the economy.

The federal Government's budget position has improved markedly since its adoption of the Fiscal Responsibility and Budget Management Act, which envisages an annual reduction of at least 0.3 percentage points in the fiscal deficit (Figure 3.17.13). Buoyancy in tax collections allowed for a reduction in the deficit in FY2007 to an estimated 3.1% of GDP, marginally below target. The federal budget for FY2008 has projected a further decline to 2.5%, and has proposed a rationalization of the income tax structure by raising tax exemption limits and by restructuring tax slabs. The corporate tax rates remain the same. More needs to be done though, such as broadening the tax base, rationalizing subsidies, reducing tax exemptions,

3.17.9 Oil and fuel price indexes



Sources: Datastream; CEIC Data Company Ltd.; both downloaded 17 March 2008.

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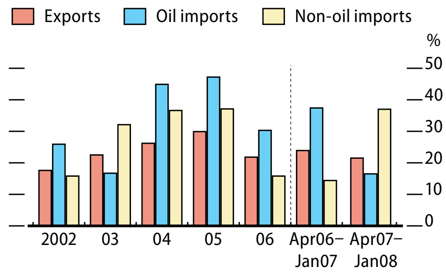
3.17.10 Growth of trade



Source: CEIC Data Company Ltd., downloaded 24 March 2008.

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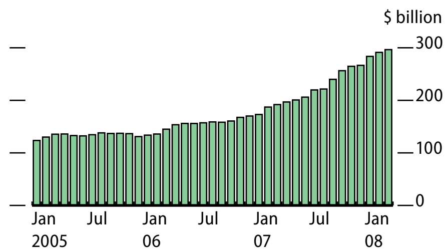
3.17.11 Foreign exchange reserves



Note: Data for March 2008 is until 14 March only.

Sources: CEIC Data Company Ltd.; Reserve Bank of India, *Weekly Statistical Supplement*, 7 March 2008 and 21 March 2008, available: www.rbi.org.in; downloaded 24 March 2008.

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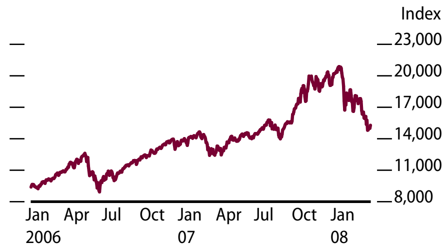
and improving tax administration. The fiscal consolidation strategy has to date been led by revenue growth in a rapidly expanding economy, but the quality of expenditure may at times be questioned.

This last budget before the general elections in 2009 had a populist stance on spending for health, education, and rural infrastructure, which is also in line with the 11th Plan strategy of inclusive growth. A central feature of the stance was a farm-loan waiver estimated at Rs600 billion, or almost 1% of GDP. This proposal, however, could generate moral hazard. Moreover, the waiver does not address the issue of this problem resurfacing in the future. Funding of the waiver was not included in the budget.

These federal deficit numbers do not present India's complete fiscal picture of FY2008 for four key reasons. First, the deficit incurred by state governments is excluded (a much higher deficit emerges if it is included). Second, the civil service pay increase recommended by the Sixth Pay Commission (announced after the budget), which would cost the federal Government $3.1 billion in FY2008 if implemented, was not provided for. Moreover, it will have knock-on effects for state budget deficits. Third, the cost of various off-budget items, such as oil bonds and losses of state-owned electricity companies, are excluded. Fourth, isolating domestic prices from rising international food prices needs additional budget financing during the year.

Adding all four items would lift the total general government deficit significantly. Not only is fiscal consolidation hindered by these exclusions, they continue to add to a public debt that is equivalent to about 80% of GDP, among the world's highest. Debt service squeezes the fiscal space needed for essential public infrastructure investment. Indeed, interest payments are projected to rise by 11% in FY2008 and equal just over 30% of expected total revenue receipts.

3.17.12 Sensex



Source: Datastream, downloaded 25 March 2008.

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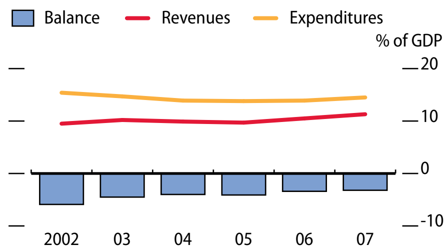
3.17.13 Central government fiscal indicators



Sources: Reserve Bank of India, *Handbook of Statistics on Indian Economy*, available: www.rbi.org.in; Ministry of Finance, *Budget at a Glance*, available: http://indiabudget.nic.in/; Central Statistical Organisation, available: www.mospi.nic.in/cso.htm; all downloaded 25 March 2008.

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Economic prospects

Forecasts for FY2008 and FY2009 are based on five assumptions for the economy: the domestic food supply position will remain tight though manageable in FY2008, but improve in FY2009; RBI and the federal Government will take all steps necessary to contain inflation in FY2008, largely because of the general elections due by early 2009; monetary conditions will be relatively more accommodative during FY2009; substantial revisions in domestic price of petroleum products will likely be made only in FY2009 (that is, after the elections); and the rupee-US dollar exchange rate will remain relatively stable throughout the period.

Following the slowdown that began in FY2007, economic growth will likely moderate further to 8.0% in FY2008. Overall GDP growth in FY2009 is predicted to return to around 8.5%, nudged along by a broad-based pickup in spending (Figure 3.17.14). Even though growth has faltered, the economy has built up considerable momentum in recent years and this sense of dynamism should help pull up the pace again. However, major macroeconomic challenges need to be met in order to ensure that the current deceleration remains mild in the face of turmoil in global financial markets and of the marked economic slowdown in industrial countries.

The growth outcomes in the economy over the next 2 years will depend in part on the timing and scope for relaxing the present tight

3.17.1 Selected economic indicators

	2008	2009
GDP growth	8.0	8.5
Wholesale price inflation	4.5	5.0
Current account balance (% of GDP)	-2.2	-2.6

Source: Staff estimates.

monetary policy. Exactly when this will be feasible will be determined by success in containing inflation, which in turn depends on two uncontrollable factors: the outturn in domestic food production and the course of international commodity prices. The good news is that global oil prices have come off historical highs and are showing signs of returning to levels assumed for the projections.

Growth in international commodity prices is expected to flatten in FY2008 and fall in FY2009, taking the pressure off inflation and allowing domestic demand to pick up in FY2009. Private consumption expenditure will remain relatively buoyant in FY2008 at just over 6%, supported by continued strong wage gains in a skills-short formal economy, larger income tax exemptions, the debt waiver for farmers given in the FY2008 budget, higher prices for cash crops in the rural economy, and higher pay for civil servants. Government consumption expenditure will also rise, to support the ambitious social sector development agenda of the 11th Plan.

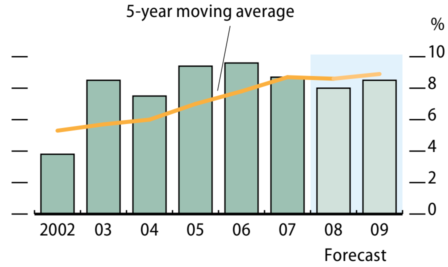
Reinvestment of corporate profits, capital inflows, and credit availability will continue to support investment growth. But while investor enthusiasm remains high, drawing on a broad range of new business opportunities and high capacity utilization in existing plants, expansion in fixed investment is projected to slow in FY2008. It will account for about half of the decline in economic growth, although this will be partly offset by some cyclical building of inventories. Postponement of initial public offerings in early 2008 is one indicator that the expansion plans of many Indian companies are being scaled back. Much of the deceleration in investment is expected to stem from slowing property development.

Easing of lending rates and revival of the consumer durable goods sector and construction activities are important for achieving a pickup in industrial growth. But despite the current slowdown in demand, lending rates cannot be reduced because stabilizing inflation at a moderate level remains the priority of RBI during FY2008, even at the cost of growth. A more accommodative monetary policy stance is expected only after the general elections. After that, RBI is likely to move to ease its tight policy stance by reducing policy rates if food inflation is relatively well controlled. A fall in borrowing costs, together with growing consumption demand, would lift industrial production in FY2009 after an initial hitch in FY2008.

Agricultural growth will continue to be driven by monsoons until better infrastructure and institutional set-ups are in place. The 11th Plan emphasis on agriculture, coupled with a Rs2,800 billion target set for agricultural credit in FY2008, as well as a host of reform measures for agriculture and water resource management announced in the FY2008 budget, should take hold and lead to the needed improvement in agricultural performance in FY2009. This would be supported by additional measures likely to be proposed by the committee established by the Government for that purpose.

Domestic prices, especially of food and fuel, will be critical in determining wholesale price inflation, which is projected to be at a moderate level of 4.5% in FY2008 (Figure 3.17.15). Inflation pressure, however, will persist as the domestic output of foodgrains and vegetables is expected to remain tight in FY2008 due to subdued sowing of the winter crop in October 2007. The tight supply position of wheat, pulses,

3.17.14 GDP growth



Sources: Central Statistical Organisation, available: www.mospi.nic.in/cso.htm, downloaded 24 March 2008; staff estimates.

Click here for figure data

edible oil, and coarse cereals appears due to diversification to cash crops and water shortages in parts of the country. Easing of international prices of nonfuel commodities, including foodgrains, will help in augmenting domestic supply.

It is unlikely that the federal Government will significantly revise the domestic prices of petroleum products before the general elections. After the large increase in the average price of the Indian crude basket in FY2007, it is expected to rise further by about 10% in FY2008. The required level of subsidy would then be so large as to prompt several rounds of small revisions in domestic prices of petroleum products with some cascading impact on the prices of other commodities. Domestic oil-price adjustments would be relatively modest, as gaining political support for any increase is difficult. With an easing in food inflation in hand, overall inflation is projected to be held to 5% in FY2009.

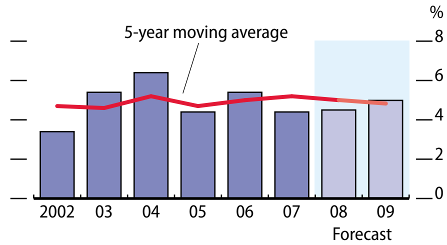
Several low-profit-margin exports such as textiles and handicrafts were hurt by the rupee's appreciation in 2007, but exports of more sophisticated products such as capital-intensive manufactured goods, as well as sales of business services, continued to expand. However, the rupee-US dollar exchange rate is assumed to remain relatively stable during FY2008 and FY2009. In the outlook, exports are therefore expected to grow at about 16–18%, partly due to the sizable share in the total (nearly 20%) of refined petroleum products, whose prices are on the rise.

Moreover, markets other than the US are also opening up to India's high-tech service exports such as information and communications technology and business process outsourcing, which provide a cheaper source of supply to increasing demand from industrial economies. Indian exporters have started diversifying to other major export markets, notably Europe, People's Republic of China, and the rest of Asia. Import growth will continue to be rapid, reflecting both high international oil prices and expansion in non-oil imports, especially of capital goods and intermediates that have become necessary to sustain high levels of investment. These factors have been incorporated in the projection of a widened current account deficit, which is likely to be around 2.2–2.6% of GDP.

Realized performance may of course depart from this outlook for a raft of reasons. Monetary management may have to deal with the possibility of supply shocks beyond the 2007 and 2008 sowing seasons. The loan waiver can be effective in augmenting food supply provided that farmers are also supported with a comprehensive package of technology, services, and public policies related to input and output pricing. Rising food prices, especially of commodities consumed by the broad public, would damp their general purchasing power and GDP growth. Moreover, in the event of high food prices, monetary conditions would need to remain tight, and the assumed move to lower lending rates would not occur and growth would be less.

More generally, the global slowdown may more adversely affect India's engineering and other high-end exports as well as earning from sales of software and other business services than projected. While this would raise the negative impact of "net exports," the main damage would be seen in the erosion of the exuberant business outlook. If a larger part of the private sector turns cautious and waits to see what happens next, investment and growth would fall below those projected.

3.17.15 Wholesale price index inflation



Sources: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 19 February 2008; staff estimates.

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Development challenges

Over the past decade, India has undergone a transformation and climbed to a high-growth path as macroeconomic and structural reforms reduced regulation, improved the business environment, and opened the economy to greater competition. Yet it still needs to focus on certain key areas with the potential to push growth to a higher plateau. The most crucial are enhancing the policy and regulatory framework to encourage the private sector and reining in fiscal deficits. A dynamic private sector that creates jobs, increases productivity, and invests in the economy plays a crucial role in bolstering growth. Removing the bottlenecks to private sector growth and competition in India could well generate an additional 2% of GDP growth.

All levels of government need to reengineer their laws and procedures to reduce barriers to entry of firms into any product area; modernize outdated and excessive regulations, and introduce more flexibility in the labor code; eliminate the roadblocks that hinder free interstate movement of goods to achieve a competitive national market; and end the present lengthy process required to restructure or close bankrupt companies. Archaic management structures and institutions still prevail in much of the daily working of government. Thus reengineering needs to be introduced into institutions at all levels through adoption of the management and operating techniques so successfully developed by India's computer software and business services industries. These changes would be especially effective in local government.

Fiscal consolidation, by targeting combined state and federal government deficits, including off-budget and contingent liabilities, is needed to create the fiscal space for essential social and infrastructure spending. Yet the Government's decision to keep domestic prices artificially suppressed in response to rising international food and oil prices has distorted product prices and generated large, annual off-budget liabilities that are rapidly increasing the already heavy deadweight of interest payments.

Aligning food prices with the international market would raise farmers' incomes and set prices that would not distort land allocation to crops. A similar move for oil will likewise give consumers the right price signal to save energy and to demand more energy-efficient products. A part of the saving from ending these subsidies could then be available for direct cash payments in well-targeted safety net programs. This would eliminate the large diversions and losses involved in the present price-subsidy schemes.

Declining labor productivity is a key issue in sustaining India's long-term growth. Defined as output per worker, it fell from an average of 5.8% from FY1993 through FY1998 to 3.6% from FY1999 through FY2004. One reason is an increasing shortage of appropriate skills (Box 3.17.1).

3.17.1 Attacking shortages of skills and infrastructure

Although 90% of employment opportunities require vocational skills, only 10% of educated young people are equipped with them. Almost two thirds of young workers have below primary or no education and about 90% of them hold low-quality, informal sector jobs.

An estimated 80 million young workers need up to 2 years of training for skills "repair." Only about 15% of manufacturing firms provide on-the-job training, which raises their productivity by a quarter above those that do not.

The bottleneck needs to be addressed at three levels: training for informal sector skills, entrepreneurial and managerial competency, and high-end professional skills.

The Government has embarked on a skills development mission to impart the required training, but covering the entire gamut of skills required through public funding may be neither financially feasible nor economically desirable. A new approach is needed to leverage the private sector for investment in education and training, on-the-job training programs in firms, and increasing private participation in higher education.

However, it is poor infrastructure that has emerged as the most important constraint to growth, and needs an estimated $500 billion of investment. The Government has undertaken several initiatives in power, national highways, and urban infrastructure, but public resources alone will not suffice. What is required is a streamlining of regulations and a facilitation of competition in infrastructure markets, in order to encourage private sector participation.