India

Asian Development Outlook 2007 (ADO 2007), published in March this year, noted concerns about the economy overheating, but forecast a soft landing piloted by higher interest rates, exchange rate appreciation, agricultural expansion, and measures to tame the real estate boom. Since then, the rupee has appreciated substantially, interest rates have risen further, the spring harvest was healthy, and the property boom is approaching maturation. So—has a soft landing been achieved?

This *Update* concludes that the economy is on a proper glide path. However, a firm hand on the joystick is needed and this was seen in the tightening of monetary policy at end-July. While overall inflation has moderated, food price inflation remains high, monetary expansion is well above the policy target, and overall demand momentum is staying strong. Still, with continued policy vigilance, the *Update* projects growth tempering to 8.5%, inflation being kept in check, and the current account deficit remaining easily manageable.

Updated assessment

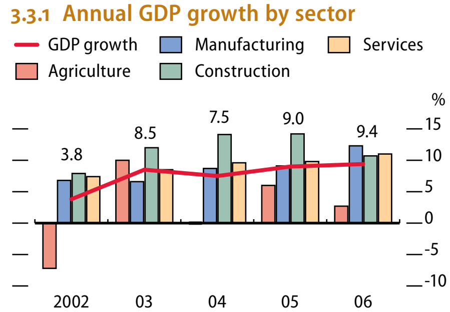
For 4 successive years, GDP has expanded rapidly, placing India among the world's fastest-growing and most vibrant economies. Revised estimates indicate that GDP expanded by 9.4% in FY2006 (ended March 2007)—the highest rate in the last 18 years (Figure 3.3.1). During the fiscal year, manufacturing, up by 12.3%, came into prominence as a source of growth, exceeding the 11% rise in services, the traditional mainstay. GDP from agriculture, which is volatile year to year according to the monsoon, grew by 2.7%.

The economy continued its momentum in the first quarter of FY2007 (April–June 2007) with GDP rising by 9.3%, only slightly lower than the 9.6% quarterly expansion a year earlier (Figure 3.3.2). Sector-wise, the pattern of growth also showed little change: agricultural growth picked up to 3.8%, while expansion in services moderated slightly. The authorities expect growth to ease further to the range of 8.5–9.0% for FY2007 as a result of monetary policies to prevent overheating and to keep inflation in check.

The economy is essentially driven by domestic demand and, unlike many other Asian countries, net exports generally have a small negative impact on growth. Buoyed by a combination of rising corporate profitability, robust credit from banks, and growing business confidence, fixed investment has expanded much faster than consumption in recent years, helping move the economy to its new high-growth path. Notably, the fixed investment-to-GDP ratio has climbed by nearly 6 percentage points over the last 4 years to 29.5% in FY2006, and accounted for over 40% of growth that year. In the first 3 months of FY2007, fixed investment continued to strengthen, to 31.3% of GDP.

The rapid transformation of the economy was especially evident in

3.3.1 Annual GDP growth by sector



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 3 September 2007.

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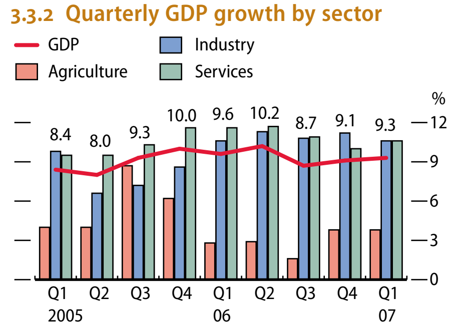
3.3.2 Quarterly GDP growth by sector



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 3 September 2007.

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FY2006. Domestic companies, traditionally "home biased," quadrupled their direct investment abroad to $11 billion as they sought new markets and technology. At the same time, (inward) foreign direct investment (FDI) expanded by 150% to $19.4 billion as global companies worked to establish or expand their presence in the country. Corporate profitability has grown by 30% annually in the 4 years through March 2007, while the Bombay Stock Exchange Index (SENSEX) has posted average gains of 44%. Nevertheless, a large section of the population has experienced little direct benefit from this high-growth era and a major challenge for policy makers is to find ways to further expand on the market-oriented reforms that have created this dynamism, while maintaining broad-based public support.

Above-trend growth has led to demand management pressures as the near elimination of excess capacity in manufacturing added to pressures on prices caused both by escalating and volatile international oil and food prices, and by wide variations in agricultural production. The Reserve Bank of India (RBI) has adapted its monetary policy to new developments aimed at maintaining price stability, while ensuring a credit and interest rate environment supportive of exports and investment demand.

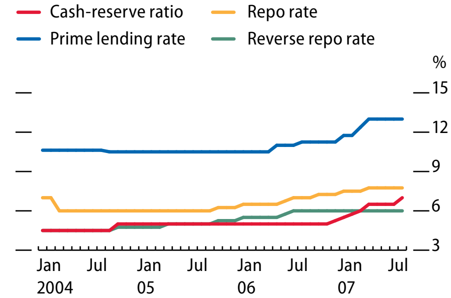
Figure 3.3.3 shows the series of tightening moves in policy rates that RBI has made in recent years to contain excessive demand pressures. In FY2006, it raised its repo rate (the rate at which banks borrow reserves from RBI) by 125 basis points to 7.75% and pushed up banks' cash-reserve ratio by 100 basis points to 6.0%. In response, banks' minimum prime lending rate increased by about 200 basis points over the year to 12.25%. Yet expansion in the money supply during the year still exceeded its target.

Monetary movements in the first 4 months of FY2007 show money supply growth remaining unabated at around 22% at end-July, well above RBI's target range of 17–17.5%, which was set for containing inflation below 5% (Figure 3.3.4). Moreover, growth in reserve money accelerated to 28.8%, driven by RBI foreign exchange purchases. These stemmed from a surge in capital account inflows that began in FY2006, and from a temporary drawdown in government net deposits. Marked excess bank liquidity resulted (i.e., reserve holding above requirements), causing the interbank money market rate to plummet to only 0.7% in July. (This situation of such excess bank liquidity, if sustained, would stoke excessive monetary expansion and high inflation.)

In response to these developments, RBI raised banks' cash-reserve ratio to 7.0% (on 4 August), adjusted regulations to damp borrowing from abroad by Indian companies (which had been feeding the marked rise in capital inflows), and ended a policy (adopted in March 2007) that limited the amount of its liquidity-absorbing reverse-repo transactions in its open-market operations. These actions appear to have brought call money market rates in August back into RBI's policy rate channel—a prerequisite for putting money supply growth on the intended track (Figure 3.3.5).

As measured by the wholesale price index, year-on-year inflation increased steadily from 4.1% at end-March 2006 to 6.7% in January 2007; remained stubbornly high through March; then moderated to 4.4% by July (Figure 3.3.6). The decline is attributed to three main elements: some easing of food prices on better supplies (though at nearly 10% food

3.3.3 Policy and prime lending rates



Source: Reserve Bank of India, *Annual Report*, various years, available: http://www.rbi.org.in, downloaded 3 September 2007.

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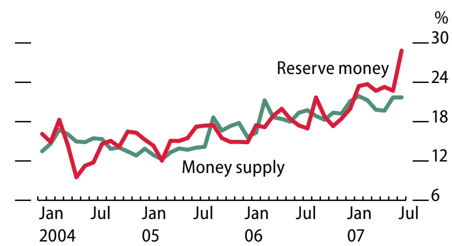
3.3.4 Monetary indicators



Source: CEIC Data Company Ltd., downloaded 28 August 2007.

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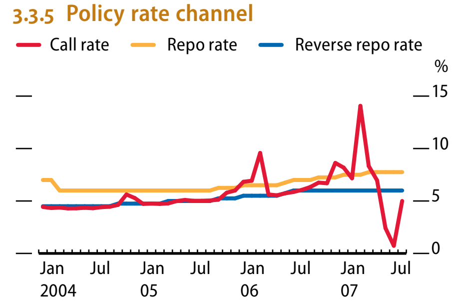
3.3.5 Policy rate channel



Source: Reserve Bank of India, *Annual Report*, various years, available: http://www.rbi.org.in, downloaded 3 September 2007.

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inflation remains high); an unusual negative impact on inflation by the fuel component as a result of reductions in the controlled retail prices of gasoline and diesel in February and March 2007 (crude costs had declined through January) that has now, in a base effect, put retail prices below year-earlier levels; and a reduction in manufactured goods inflation (to 4.9% in July), which carries a 64% weight in the index.

This last factor is a direct outcome of tightened monetary policy. The outlook for commodity prices reinforces the need for reining in those demand pressures that are most susceptible to tighter credit policies, namely consumer and real estate credit. Also, RBI has tightened risk weights and provisioning requirements as part of prudential policies to avoid excessive growth in consumer and real estate credit. Higher interest rates appear to have had little impact on business investment: a very buoyant longer-term outlook has apparently overridden a cyclical rise in borrowing costs.

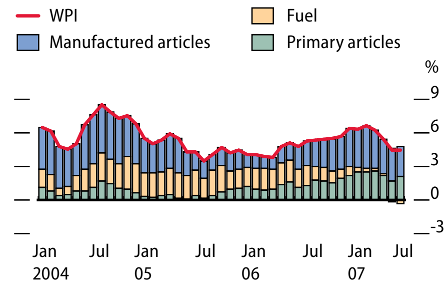
Volatility in international oil prices is a major concern. The average cost of the Indian crude basket, which reached a recent low of $52.62 per barrel in January 2007, rose to $72.70 per barrel in July 2007, resulting once more in a growing discrepancy between domestic and international price levels (Figure 3.3.7). Total "underrecoveries" (caused by the difference between the domestic selling prices and their ex-refinery costs) of the state-owned oil-marketing companies was Rs129 billion (about $1.6 billion or 1.2% of GDP) in the first quarter of FY2007 when crude costs averaged $66.50 per barrel. In FY2006, the Government issued bonds amounting to Rs241 billion related to losses of these companies. Growing financing costs, as a result of a higher crude oil bill, are likely to raise pressure on the Government to make some revision in domestic prices of gasoline, diesel, and cooking gas.

Balance-of-payments data for FY2006 show growth in exports of 20.9% and imports of 22.3%, and the trade deficit widening to $64.9 billion (Figure 3.3.8). This deficit was significantly offset by robust inflows from invisibles, which included earnings from services such as sales of software, call centers and other business services, and private transfers from Indians working abroad. The current account deficit rose marginally from a year earlier to $9.6 billion, staying at only 1.1% of GDP.

However, the capital account surplus, which has been on a rising trend (Figure 3.3.9), nearly doubled from a year earlier to $44.9 billion, driven largely by a surge (to $16.1 billion from only $2.7 billion) in commercial borrowing by Indian companies. With this jump in capital inflows, the overall balance-of-payments surplus escalated to $36.6 billion from $15.0 billion (including a relatively small errors and omissions item). This made managing monetary aggregates difficult. Much of the increase took place in the latter part of the fiscal year. The $19.4 billion in FDI inflows was counterbalanced by increased Indian investment abroad, yet net direct investment flows as a whole almost doubled to $8.4 billion. Net portfolio investment fell to $7.1 billion from $12.5 billion.

Customs data recorded robust growth in exports and imports during the first 4 months of FY2007 (April–July 2007). Exports increased by 18.2% year on year while imports (c.i.f.) posted a sharp rise of 30.7%, widening the trade deficit to $25.6 billion, or $9.8 billion higher than a year earlier. Although FY2007 balance-of-payments data are unavailable,

3.3.6 Contributions to wholesale price inflation



Source: Reserve Bank of India Database on Indian Economy, available: https://reservebank.org.in/cdbmsi/servlet/login/, downloaded 3 September 2007.

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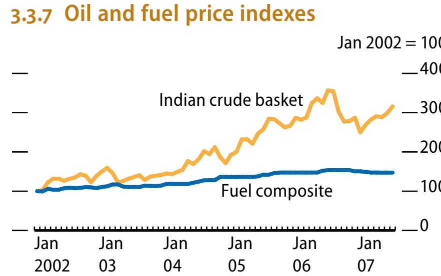
3.3.7 Oil and fuel price indexes



Notes: The Indian crude basket has been converted to rupees prior to indexing. The fuel composite is the weighted average of the wholesale price inflation for petrol, high speed diesel oil, LPG, and kerosene.

Sources: Reserve Bank of India Database on Indian Economy, available: https://reservebank.org.in/cdbmsi/servlet/login/; CEIC Data Company Ltd.; Indian Oil Corporation, available: http://www.iocl.com, all downloaded 28 August 2007.

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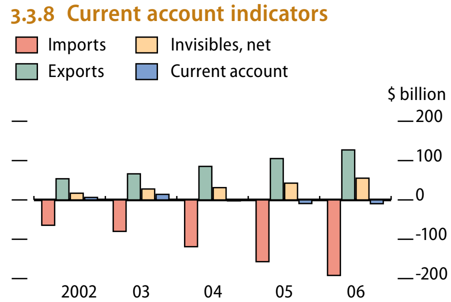
3.3.8 Current account indicators



Source: CEIC Data Company Ltd., downloaded 3 September 2007.

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developments in the trade balance and foreign exchange reserves indicate that capital inflows have remained high (Figure 3.3.10).

The exchange rate of the rupee against the US dollar showed two main movements in FY2006: an initial trend to depreciation through July, then appreciation to end-March 2007 at which time the rate was Rs43.60/$1, for a moderate strengthening of 2.3% over the year. The real effective exchange rate was essentially unchanged (Figure 3.3.11). In the first quarter of FY2007, reflecting continuing pressures from capital inflows and limited RBI intervention to fully offset market trends, the rupee-dollar rate appreciated quickly by about 7% to reach Rs40.8/$1 at end-June 2007, and held steady through August, while the real effective exchange rate appreciated by about 9% over the same period.

This abrupt change raised the alarm among a slew of important foreign exchange earners, from textiles and clothing companies, which operate on thin margins and confront stiff competition in international markets, to the information technology industry, which receives payment mainly in dollars and, in addition, faces rapidly escalating (rupee-denominated) wages for its staff.

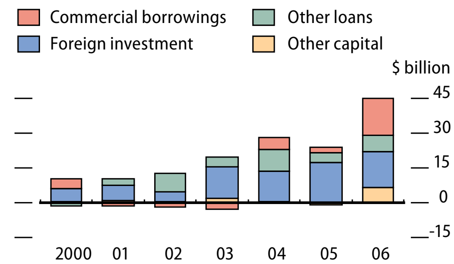
The present policy issues of sound monetary management and appreciation of the rupee illustrate the problems associated with the *impossible trinity*—the incompatibility of an open capital market, a fixed exchange rate, and an independent monetary policy. While India's capital account is not fully open—a longer-term goal to maximize economic efficiency recommended to the Government by an official study—it has been liberalized in recent years both with respect to inflows and outflows.

Even with a growing current account deficit, RBI has had to intervene to avoid sustained upward pressure on the exchange rate, which could have retarded development of the country's relatively small export base. RBI sterilized its foreign exchange intervention—i.e., offset expansion in reserve money and monetary expansion—by selling from its holding of government securities. By 2004, its holding had fallen significantly and had to be augmented by special issues of such securities solely for intervention under the Market Stabilization Scheme. The authorities also used increases in the cash-reserve ratio to neutralize growth in reserve money. Both efforts, however, pushed up domestic interest rates and encouraged further capital inflows.

The surge in commercial borrowing from abroad in FY2007, as well as the weight of growing interest costs for stabilization, induced the authorities to let the rate strengthen in the market. The revised limits on commercial borrowing from abroad (effective August 2007) will likely take the immediate pressure off the exchange rate and help RBI put monetary policy on a better footing. Underlying economic fundamentals, however, determine the real exchange rate, and market-oriented reforms of recent years have sparked productivity gains that will likely continue. This will make for further tension in managing monetary and exchange rate policies. The authorities will have to continue making fine judgments on policy, since capital flows are fickle and businesses tend to be wary of developments that force them into a tighter operating environment.

The stock market continues to please those who have invested, as indicated in Figure 3.3.12. The market quickly recovered from a correction in February–March 2007 associated with a bout of global jitters over risk

3.3.9 Capital account



Source: CEIC Data Company Ltd., downloaded 28 August 2007.

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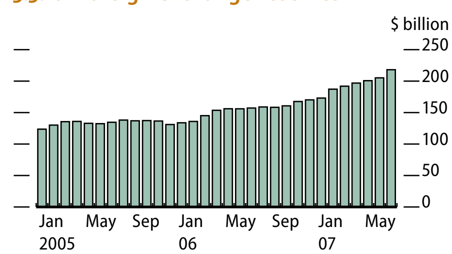
3.3.10 Foreign exchange reserves



Source: CEIC Data Company Ltd., downloaded 3 September 2007.

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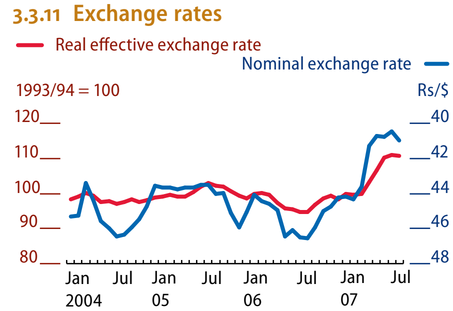
3.3.11 Exchange rates



Sources: Reserve Bank of India Database on Indian Economy, available: https://reservebank.org.in/cdbmsi/servlet/login/, downloaded 21 August 2007; staff estimates.

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(which affected markets in most industrial and developing countries) and then advanced markedly through mid-July, at which point turmoil in global credit markets sparked another slide. Since mid-August, most of the lost ground has been retraced, with the SENSEX posting a 30.9% advance for the year through end-August. (Foreign institutional investors are limited to an aggregate investment of $5 billion annually.)

Prospects

The *ADO 2007* forecasts for FY2007 and FY2008 were based on five assumptions. This *Update* keeps four of the five: continued fiscal discipline, further tightening of monetary conditions, still-moderate agricultural growth, and a modest appreciation of the real effective exchange rate. However, the assumption of no revision in prices of gasoline, diesel, kerosene, and cooking gas looks less tenable because of increased crude oil prices. The timing of any price revisions of petroleum products, however, will depend to a large extent on the stability of food prices.

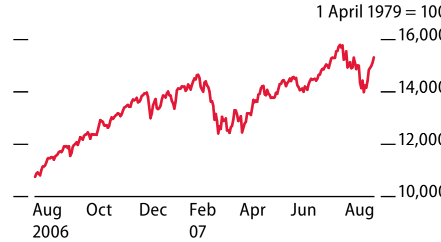
ADO 2007 expected that restraints on demand growth from homebuyers, manufacturing investors, and consumers would moderate the growth rate to 8.0% in FY2007. Developments to date suggest an upward revision to the growth forecast for the year, and a marginal upward revision for FY2008. Widespread capacity constraints, robust corporate profits, and the ongoing expansion of capital goods production imply that hardening interest rates are unlikely to dent investment, which will continue as a main driver of growth. Interest rate rises, however, will encourage consumers to put off spending, leading to a reduction in demand for consumer durables, and will damp the pace of construction activities as well.

Industrial production in July grew by only 7.1% from a year earlier, due to stagnation in durable goods manufacturing (though other sectors remained strong). For the first 4 months of FY2007 (April–July) it averaged 9.6%, and is now, riding on robust investment and capital goods production, expected to accelerate to around 10.5% in FY2007, pushing up GDP growth by a half percentage point to 8.5%. The forecast for FY2008 is revised marginally upward to 8.5%.

The general government deficit has been on a declining trend in recent years (Figure 3.3.13). Fiscal responsibility legislation adopted by the federal Government in mid-2004, and subsequently by most state governments, calls for an improvement in the overall deficit to at least 3% of GDP by FY2008. The federal government budget for FY2007 plans for the overall deficit to fall (by 0.4% of GDP) to 3.3% of GDP. Buoyant tax revenues in the first quarter of the fiscal year suggest that the deficit target should be met, as key fiscal indications showed improvement relative to prior-year levels (though the pay recommendations, due in 2008, of the Sixth Pay Commission for government employees could affect the ability of the federal and state governments to maintain the pace of fiscal consolidation).

Rising food prices were one of the causes of recent inflation. Conditions for agriculture are conducive for good growth in FY2007. Rainfall is predicted to be near normal. To enhance the supply of pulses,

3.3.12 Sensex movements



Source: Reserve Bank of India Database on Indian Economy, available: https://reservebank.org.in/cdbmsi/servlet/login/, downloaded 31 August 2007.

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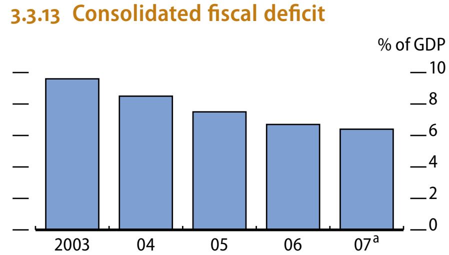
3.3.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	8.0	8.5	8.3	8.5
Inflation [a]	5.0	5.0	5.0	5.0
Current acct. bal. (share of GDP)	-2.2	-1.6	-2.2	-1.9

[a] Wholesale price basis.
Source: Staff estimates.

3.3.13 Consolidated fiscal deficit



[a] Revised government estimate.
Source: Reserve Bank of India, *Annual Report 2006–07*, available: http://www.rbi.org.in, downloaded 3 September 2007.

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the federal Government has decided to import 1.5 million tonnes of them. Domestic wheat procurement by government agencies during April–May 2007 was higher than the same period 12 months earlier. The Government has also decided to import 0.5 million tonnes of wheat to augment its buffer stock. With a positive outlook for domestic food supplies and tightened monetary policies, the inflation forecast (wholesale price index) is unchanged from *ADO 2007* at 5.0% for FY2007 and FY2008 (despite some upward adjustment in domestic fuel prices). Inflation risks persist though, and any shock to food prices, and any larger revision in domestic prices of petroleum products (which is needed), are causes for special concern.

The current account deficit was substantially lower in FY2006 than was expected when *ADO 2007* was prepared. This is primarily attributed to much lower growth in imports (22.3%) as against 26% assumed in *ADO 2007*. It is expected that imports will grow faster than forecast in *ADO 2007* due to hardening international oil prices, but from a lower base. Accordingly, the current account forecast for FY2007 reflects a smaller deficit of $18.2 billion in FY2007, or 1.6% of GDP, down from *ADO 2007's* 2.2% deficit. Similarly, a current account deficit of $24.5 billion, or 1.9% of GDP, is now forecast for FY2008 (with both ratios taking account of the higher nominal GDP).

The key risks to the above outlook emerge from shocks that would undermine fiscal or monetary discipline or radically affect food or fuel prices. Marked further appreciation of the rupee would likely have an adverse impact on exports and corporate profitability in export-oriented sectors. Finally, the recent disturbances in global financial markets might snowball into a global credit crunch, with obvious adverse macroeconomic implications for India.