India

The Indian economy experienced high and broad-based growth over the past fiscal year. Inflation has been the main challenge for policy makers, with the observed pattern of price increases highlighting the need to tackle decisively weaknesses along the domestic agricultural supply chain. Weaker global trade growth and a necessary further tightening of fiscal and monetary policies will slow economic growth marginally in the new fiscal year. However, progress on fiscal consolidation and success in easing supply-side constraints will pay off the following year.

Economic performance

The economy grew by 8.6% in FY2010 (ending March 2011) according to the government's advance estimates. Growth has been broad-based and driven by a solid recovery in agriculture and continued good performance of industry and services (Figure 3.17.1).

Helped by a good monsoon that boosted the *kharif* (summer) crop, agriculture is estimated to grow by 5.4% in FY2010, after 0.4% in FY2009, when a deep and widespread drought (and subsequent flooding) held back farming. Foodgrain production, estimated at 232 million tonnes in FY2010, is 6.4% higher than FY2009's output (though still lower than the record 234 million tonnes in FY2008).

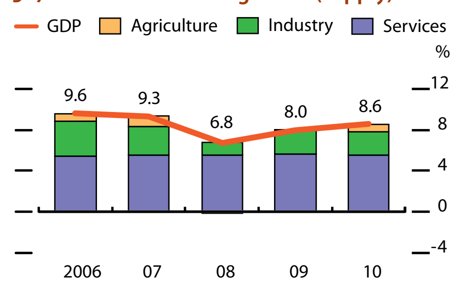
While industry is estimated to record healthy growth of 8.1% in FY2010, the second half saw a moderation of growth. In particular, after growth of 10.1% in the first half, industrial output growth slowed to single-digits in the second.

The main contributors to strong growth in the first half of FY2010 were consumer durables and capital goods. Important infrastructure sectors, such as crude oil, petroleum refining, electricity, and steel, also performed well. Apart from the base effect, the deceleration in the second half has been driven by a slowdown in capital goods production owing to a slowdown in investment. While it is difficult to pin down the exact cause of the investment slowdown, delays in obtaining environmental clearances, difficulties with land acquisition, and the lack of progress on some expected policy reforms may have played a role.

Services are estimated to grow by 9.6% in FY2010, a little lower than the 10.1% growth registered in FY2009. Key drivers included the trade; hotels; transport and communications; and finance, insurance, real estate, and business subsectors. Given the dominance of services, their healthy performance is crucial for high overall growth. This sector accounted for 64% of overall GDP growth in FY2010, down from 71% in FY2009.

The drivers of growth from the expenditure side have also been broad-based (Figure 3.17.2), with healthy contributions from private

3.17.1 Contributions to growth (supply)



Source: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in (accessed 8 March 2011).

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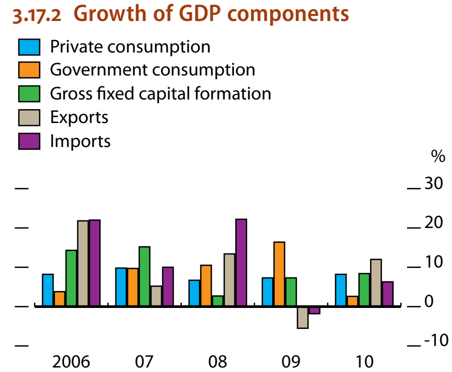
3.17.2 Growth of GDP components



Sources: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in (accessed 8 March 2011); ADB estimates.

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This chapter was written by Rana Hasan of the India Resident Mission, ADB, New Delhi.

consumption, investment, and exports. While total consumption growth slowed from 8.7% in FY2009 to 7.3% in FY2010, this stemmed from a concurrent sharp decline in growth of government consumption from 16.4% to 2.6%; growth in private consumption—which accounts for more than four-fifths of total consumption—rose from 7.3% to 8.2%.

Similarly, although growth in gross capital formation slowed from 13.8% to 8.8% over the same period, fixed capital formation edged up from 7.3% to 8.4%. Nevertheless, the full figure for FY2010 masks a slowdown in the second half when fixed capital formation growth dropped from double digits in the first half to 6% in the third quarter. In contrast, exports picked up significantly in the second half, leading net exports to contribute positively to growth for the first time in many years.

With the onset of global recovery, investment registered a marked increase from 34.5% of GDP in FY2008 to 36.5% in FY2009, driven by a rise in corporate sector investment of 1.7 percentage points of GDP. The investment rate is estimated by the Economic Advisory Council of the Prime Minister to have increased to 37%. The saving rate recovered somewhat in FY2009 to 33.7% of GDP and appears to have risen marginally to 34% in FY 2010. Both saving and investment remain, however, below their precrisis highs (Figure 3.17.3).

Inflation has been a major concern in FY2010. While monthly year-on-year rates moderated from the double-digits reached in mid-2010, they are estimated to have been 9.2% for the fiscal year. Food inflation has been an important driver, accounting for between a quarter and a third of monthly wholesale price inflation in FY2010.

Much of the initial surge in food inflation in FY2010 (Figure 3.17.4) came from the weak FY2009 monsoon's impact on output and prices of cereals, pulses, and sugar. It has later been driven by subcontinent-specific weather shocks and demand–supply mismatches, as rising incomes and shifting dietary patterns increased demand for vegetables, fruits, and high-protein items. These factors have highlighted the need for dramatically improving production and distribution systems in agriculture.

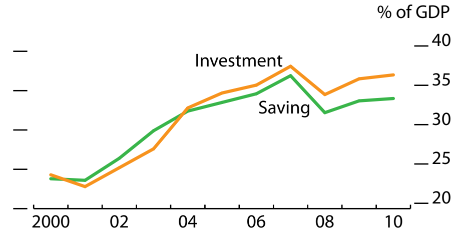
Finally, as the product-based breakdown of the figure shows, price increases in manufactured products have been important and have contributed to worries that inflation expectations are becoming entrenched.

Tackling the problem of high inflation has turned out to be complex. In response to rising inflation and a recovering economy, the Reserve Bank of India (RBI) reversed its accommodative policy stance in March 2010. The RBI has raised the repo rate (the rate at which banks borrow from it) eight times by 200 basis points in FY2010, which now stands at 6.75%; it has also raised the reverse repo rate (the rate at which it borrows money from banks) over the same period, and that now stands at 5.75% (Figure 3.17.5). The central bank also raised the cash-reserve ratio from 5.5% to 6.0% in April 2010.

The RBI recognizes that monetary policy may not be the most effective instrument to deal with supply-side pressures on inflation. But its concern is that the repeated supply shocks that have affected the economy, along with recent petroleum price increases, have generated expectations of high inflation and may contribute to future inflation. The increase in key policy rates has been partly carried out to contain such expectations.

Liquidity tightened considerably owing to an increase in credit growth

3.17.3 Saving and investment ratio



Source: Asian Development Outlook database.

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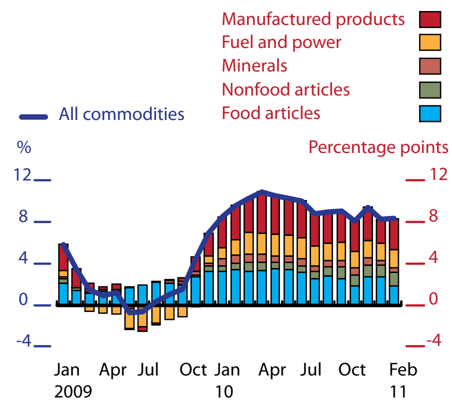
3.17.4 Contributions to inflation



Source: Ministry of Industry and Commerce. http://eaindustry.nic.in (accessed 17 March 2011).

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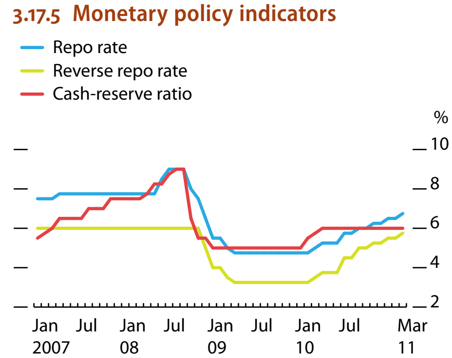
3.17.5 Monetary policy indicators



Source: CEIC Data Company (accessed 18 March 2011).

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and a fall in the deposit growth rate. The latter was driven by depressed real interest rates, withdrawal of deposits by telecoms companies to pay third-generation license fees, and purchases related to initial public offerings. To bolster deposits, banks have begun revising deposit rates upward by 50–75 basis points.

Merchandise exports are expected to climb from $175 billion in FY2009 to $230.3 billion in FY2010, but rising oil prices and resurgent domestic demand have taken imports from $295.5 billion to $362.3 billion (Figure 3.17.6), pushing out the trade deficit from $120.5 billion to $132 billion in FY2010. The first half of FY2010 also recorded sluggish performance of invisibles, largely due to the nonsoftware component of services.

As a result of these trends, the current account deficit is estimated to increase from $38.4 billion in FY2009 to $50.3 billion in FY2010. But a stronger currency and high nominal GDP growth in FY2010 means that, as a share of GDP, the current account deficit is estimated to be around 3.0%, a little higher than FY2009's 2.8%.

The capital account surplus is estimated to have improved from $47.8 billion in FY2009 to $64.6 billion in FY2010. Much of this gain is based on higher portfolio and debt flows, with the former increasing from $32.3 billion during FY009 to $38.8 billion in FY2010. These flows tend to be volatile, however, as seen by a net outflow of portfolio investment of $19.8 billion in November 2010 (Figure 3.17.7).

The upsurge in portfolio inflows was largely due to a global risk rally, leading to higher capital flows to emerging markets and interest shown in some public offerings. These flows helped the stock market to put on 30% in May–October 2010, though it has since declined by about 12.7% (Figure 3.17.8). In contrast, foreign direct investment (FDI) inflows slowed notably, from $35.6 billion in FY2009 to $27.6 billion in FY2010. The deceleration can only partly be explained by a still weak global recovery. Difficulties in land acquisition and environmental issues and slow progress of liberalization of certain sectors such as retail and insurance are likely also to have played a role.

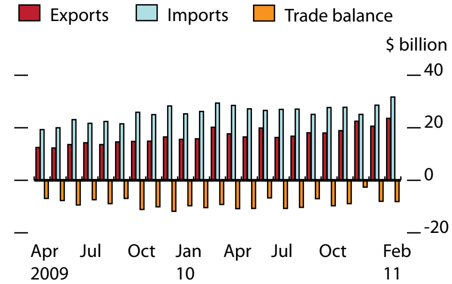
The excess of capital flows over the current account deficit resulted in accretion to foreign exchange reserves, which rose by $17.8 billion to exceed $300 billion in March 2011 (Figure 3.17.9). A part of this rise was due to valuation change as some of the major currencies appreciated against the US dollar during the year.

The rupee has remained quite stable in FY2010. It rose marginally against the US dollar. Inflation higher than in trading partners has led to a modest rise in the real effective exchange rate (Figure 3.17.10).

Better than expected revenue from the sale of third-generation spectrum for high-speed telephony and broadband services, as well as robust GDP growth, helped to reduce the central government's fiscal deficit from 6.4% of GDP in FY2009 to 5.1% in FY2010, thereby restricting the combined deficit of the center and states to around 8.1% (Figure 3.17.11). The ratio of central government gross tax revenue (including states' share) to GDP increased to 10% in FY2010, improving from 9.5% in FY2009, but it remains much lower than the 11.9% achieved in FY2007.

Despite India's strong resilience to the crisis and its ability to post robust growth rates, it has made little progress in some reforms. Moves to increase

3.17.6 Merchandise trade



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 26 March 2011).

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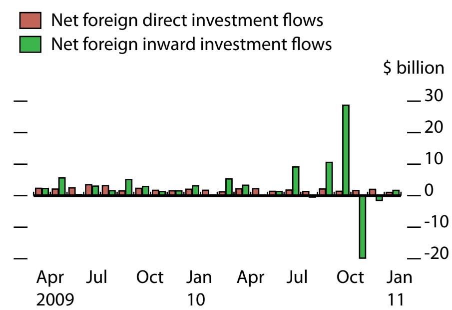
3.17.7 Investment



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 26 March 2011).

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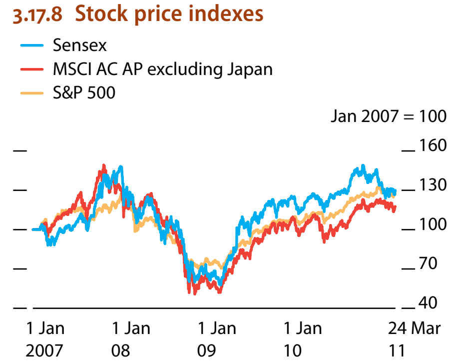
3.17.8 Stock price indexes



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

Source: Bloomberg (accessed 24 March 2011).

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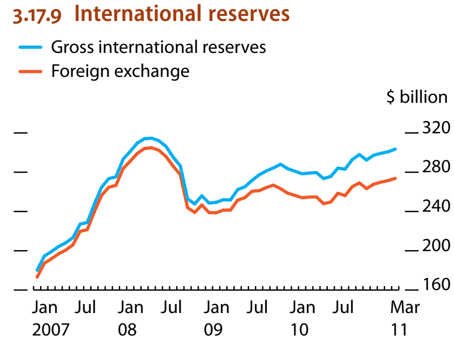
3.17.9 International reserves



Note: Gross international reserves includes gold and SDRs.

Sources: CEIC Data Company; Reserve Bank of India. http://www.rbi.org.in (both accessed 26 March 2011).

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the limit of foreign investment in sectors such as retail and insurance stalled in FY2010. Also, some major industrial projects faced difficulties in getting the required clearances from the environment ministry.

Finally and critically, the move toward a unified goods and services tax (GST), which is an important step for fiscal consolidation, slowed, with the center and states gridlocked in negotiations. The states have been concerned about losing their fiscal autonomy, which would follow from a loss of power to change tax rates. They also have anxieties that a GST would raise their dependence on central government transfers. The center and states are also discussing GST rates, as some states view the proposed revenue-neutral rates as too low. Moreover, they disagree over the taxes to be subsumed under the GST system.

Recent months have, however, seen positive steps on some of these issues. A renewed effort is under way to allow greater FDI in retail and insurance in a phased manner. The environment ministry has allowed through (with conditions) some of the projects initially denied environmental clearance but has asked promoters for some of the others to apply afresh.

On the fiscal front, there is an attempt to move toward direct cash transfers for subsidized fertilizer, liquefied petroleum gas, and kerosene, which are expected to contain the waste and misdirection of these commodities. Last, the government on 21 March introduced to Parliament a constitution amendment bill to facilitate implementation of the GST.

Economic prospects

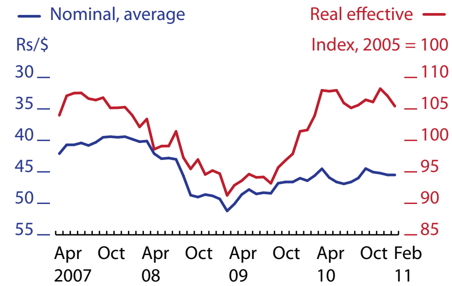
The following forecasts for FY2011 and FY2012 make several assumptions, in addition to those given in the baseline table 1.1.1 in part 1: the monsoons in both 2011 and 2012 will be normal; monetary tightening will continue in FY2011; and the government will broadly adhere to the rigorous fiscal consolidation road map suggested by the 13th Finance Commission.

While domestic pressures on inflation are expected to ease on account of normal monsoons and payoffs from the government's efforts at improving the agricultural supply chain, elevated international oil prices will exert upward pressure on prices. On balance, average inflation for FY2011 and FY2012 is expected to decline to 7.8% and 6.5%, respectively (Figure 3.17.12) on account of a high-base effect and further tightening of monetary policy by the RBI to anchor expectations.

Along with higher input prices due to rising oil prices, monetary tightening will tend to further damp private investment, which was slowing toward the end of FY2010. The government's efforts at fiscal consolidation will, however, help to provide some relief. Especially if consolidation proceeds largely as spelled out in the government's budget for FY2011—spending on subsidies is kept in check and planned infrastructure investment is not compromised—private investment may experience some "crowding in," even as the government reins in its overall spending.

Of course, elevated oil prices suggest that the government may not be able to hit its target for reducing subsidies by 12.5% in FY2011. Even with the move in 2010 to deregulate gasoline (petrol) prices, other fuel prices and natural gas remain under administrative control and the government

3.17.10 Exchange rates



Sources: CEIC Data Company; Bank of International Settlements. http://www.bis.org; (both accessed 26 March 2011).

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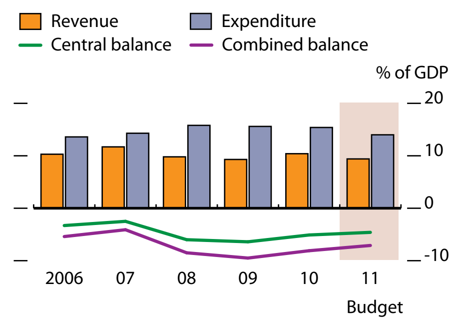
3.17.11 Fiscal indicators



Note: FY2010 is a revised, estimated budget outcome that includes the proceeds from telecoms auctions.

Source: Ministry of Finance. http://indiabudget.nic.in (accessed 21 March 2011).

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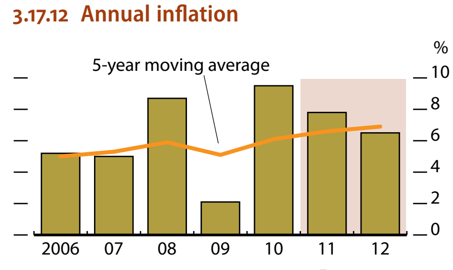
3.17.12 Annual inflation



Source: Asian Development Outlook database.

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is unlikely to raise their prices one-on-one with market conditions. Nevertheless, some reduction in subsidies should be possible and the government's intended move toward direct cash transfers of fuel-related subsidies could have far-reaching consequences in the medium term.

Based on the assumption of normal rainfall and with higher base, agriculture is expected to expand by 3%–4% in FY2011 and FY2012. In addition, proposed increases in public investment in the sector should provide it with a boost. But industry and services will remain the key drivers of growth.

At the same time, some large greenfield manufacturing projects have faced hurdles in terms of acquiring land and obtaining environmental clearance. Although these cases involve complex trade-offs between development, traditional livelihoods, and the environment, policy and regulatory clarity on these issues is crucial.

Yet the government's intention of streamlining the regulatory burden on Indian firms, and the expectation that current restrictions on FDI in multi-brand retail will be relaxed, augur well for both industry and services, especially by FY2012.

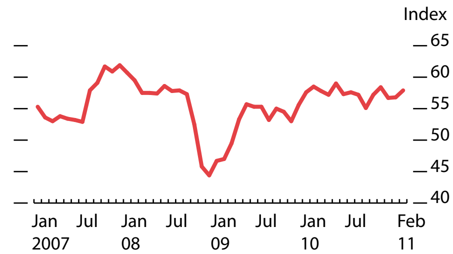
Sustaining growth also depends on external demand, which is assumed to moderate marginally following a rise in global economic risks. A survey by the HSBC Markit Purchasing Managers' Index for both manufacturing and services released in March 2011 shows some improvement, largely due to increase in orders and expansion in new business activity (Figure 3.17.13).

But there are strong downside risks, notably inflation pressure from rising oil prices. In view of the *Asian Development Outlook 2011*'s assumptions for oil prices, as well as monetary and fiscal tightening, GDP growth is expected be a little lower in FY2011 than in FY2010 at 8.2%. It should rise to 8.8% in FY2012 as reform efforts and regulatory clarity boost investment and economic activity more generally.

The current account deficit is very likely to widen over the next 2 years—fairly sharply to 3.5% of GDP in FY2011—driven by a deteriorating trade deficit and moderate growth in invisibles. While foreign capital inflows have covered this deficit relatively comfortably in recent years, trends in FY2010 flag a cause for concern.

As is well known, international flows of portfolio capital can exhibit considerable volatility and thus the slowdown in inflows of FDI to India—in contrast to the pickup observed in other emerging economies—is troubling. The recent budget has relaxed norms for foreign institutional investors in order to attract more foreign capital, especially in infrastructure. But these also need to be backed by an improvement in the regulatory environment in which firms—domestic and foreign—operate.

3.17.13 HSBC India manufacturing purchasing managers index



Source: Bloomberg (accessed 21 March 2011).

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3.17.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.2	8.8
Inflation	7.8	6.5
Current account balance (share of GDP)	-3.5	-3.3

Source: ADB estimates.

Development challenges

Sustaining high growth and ensuring that it is inclusive remains India's foremost development challenge. Even with the tremendous dynamism exhibited by services—a sector that has contributed almost two-thirds of GDP growth in recent years and now accounts for 55% of GDP and 25% of total employment—it is difficult to see how India will be able to sustain

inclusive growth without boosting agricultural productivity and further strengthening manufacturing. The latter is crucial for employing a young and growing workforce—including those released from farm work—with productive and well-paying jobs.

Agriculture has suffered a secular decline in public investment since the mid-1990s, as well as a steady increase in input subsidies such as those for power and fertilizer. The country is behind comparable countries in investing in new technology, research and development, and infrastructure. For example, it invests only 0.5 % of its agricultural GDP in agricultural research, compared with 0.7 % in developing countries as a whole and as much as 2–3 % in developed countries.

A silver lining to the high food inflation over the past year is the urgency it has generated among policy makers to engineer a second green revolution in India (Box 3.17.1).

The task of transforming manufacturing also deserves the attention of policy makers. A defining feature of India's manufacturing is the overwhelming importance of small firms and the informal sector in jobs (also known as the unorganized sector). Thus 84% of India's manufacturing employment is estimated to be in firms with fewer than 50 workers (Figure 3.17.14), whereas the corresponding shares are 25%–47% for economies such as the PRC; the Republic of Korea; Malaysia; Taipei,China; and Thailand. At small scales of operation, firms can often get caught in a vicious circle of reliance on traditional, low-productivity technologies with limited earnings and few growth prospects.

At the same time, larger enterprises—those operating in the formal (or organized) sector where both productivity and wages tend to be relatively high—have often been stymied by infrastructure and regulatory bottlenecks from expanding. As a result, although employment in the subsector grew robustly in 2004–2008, it still stood at only some 11 million (around 2.5% of the labor force).

From a policy perspective, there are two broad challenges for transforming manufacturing. For the formal subsector, much policy reform has already taken place—such as industrial delicensing in the 1990s and large-scale cutbacks in small-scale sector reservations in the early to mid-2000s.

What remains to be tackled are infrastructure bottlenecks, features of India's labor regulation that impinge on the adjustment of labor use within and across plants and sectors, and difficulties in the acquisition of land and environmental clearances for industrial activity. The government's recent announcement on a manufacturing policy that will tackle various regulatory issues is an opportunity to make headway on difficult institutional and politically sensitive issues.

For the informal subsector, and small and medium-sized enterprises in the formal sector, imperfections in credit markets and lack of awareness and access to markets and technologies add to the infrastructure-related difficulties that these firms face. While the government has in place a variety of interventions for assisting such firms in these areas, the key challenge lies in effectively delivering program services to target enterprises. To make sure that public financing is not wasted, clear benchmarks for success and failure must be adopted, and rigorous monitoring and evaluation systems must be built into the government's programs.

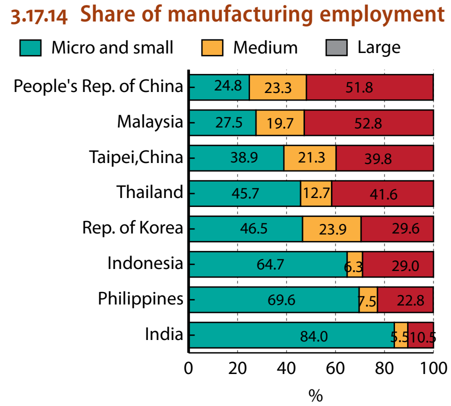
3.17.1 Transforming agriculture

The government has announced higher funding for a slew of programs aimed at dealing with production and distribution bottlenecks for fruits, vegetables, milk, meat, poultry, and fish—items that have been particularly susceptible to large price increases.

Efforts for developing "mega food parks" (for reducing wastage of fruit and vegetables for lack of storage facilities) and augmenting storage capacity and cold chains through public–private approaches are also being promoted. The government will recognize cold chains and postharvest storage facilities as an infrastructure subsector in its own right, making it eligible for any special benefits that apply.

Careful monitoring and evaluation of these efforts is needed to ensure that they have the intended effects. At the same time, state governments must review the operation of the Agricultural Produce Market Committee Act. Revamping this act would allow, for example, agro-processors, private markets, corporations, and exporters to directly deal with farmers and ease restrictions that apply to contract farming and the movement of agricultural produce from one location to another.

3.17.14 Share of manufacturing employment



Notes: Micro and small: 1–49 in all countries except Thailand (1–50 workers); Medium: 50–199 in all countries except Thailand (51–200 workers); Large: 200 or more workers in all countries except Thailand (more than 200 workers)

Source: Rana Hasan and Karl Robert Jandoc. 2010. The distribution of firm size in India: What can survey data tell us? *ADB Economics Working Paper Series* No. 213. Asian Development Bank, Manila.

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