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India

Growth further decelerated as a slump in industry and investment spread to consumption and exports. Though inflation and the fiscal deficit were reined in, the current account deficit rose to a record high. Delays in resolving structural impediments to growth were compounded by a global trade slowdown. Boosting investment is critical for a return to high growth but requires reforms to eliminate bottlenecks that are stalling projects. Recent steps to address some of these challenges are expected to help growth pick up modestly.

Economic performance

Economic growth in FY2012 (ended 31 March 2013) decelerated to 5%, its lowest rate in a decade, from 6.2% in FY2011 (Figure 3.17.1). While tepid industrial growth and a downdraft in investment continued from FY2011, the downturn was exacerbated by a slump in services activity, weakening consumption, and contracting exports.

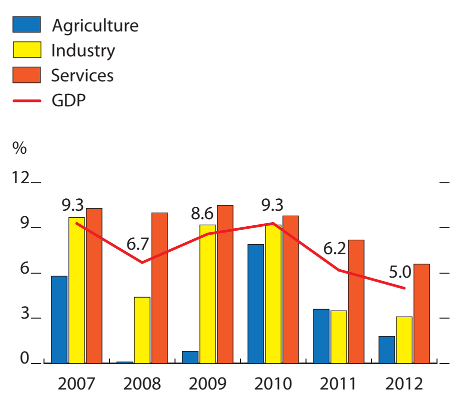
Growth in consumption expenditure halved from the previous years' average to 4.1% as private and public spending both dropped. Subdued economic activity, high inflation, a weak currency, and steep interest rates dented consumer confidence. The slowdown in public consumption reflected the containment of government expenditure in the second half of FY2012 to restrain the budget deficit.

Supply bottlenecks such as the lack of fuel for power generation, difficulty in acquiring land and environmental clearances, contentious tax policies, and procedural delays continued to stifle investment, causing growth in fixed investment to drop to 2.5% (Figure 3.17.2).

Industry in FY2012 weakened further, driven by a slump in manufacturing and mining. At 1.9%, manufacturing registered one of its weakest expansions in the post-1991 reform era as capital goods production contracted for a second year in a row. Delays over land and environmental clearances continued to hamper mining operations, keeping growth tepid at 0.4% despite a low base. Dwindling production of natural gas at a large new field caused by pricing and technical issues, and a lack of new discoveries in recent years, drove natural gas production down by 13.3%. Electricity production also moderated as thermal generation was hampered by inadequate coal supplies and hydro generation was affected by depleted reservoirs following deficient rains. Power shortages have raised firms' costs and hampered production. Construction, helped by a delayed monsoon and the resulting long dry spell, expanded by 5.9%.

The late onset of the southwest monsoon and its subsequent unfavorable progress cut agriculture growth by half to 1.8% in FY2012. Grain production is estimated to be 3.5% lower than in the previous year, reflecting a drop in the production of rice, wheat, pulses, and coarse cereals.

3.17.1 GDP growth by sector



Source: CEIC Data Company (accessed 23 March 2013).
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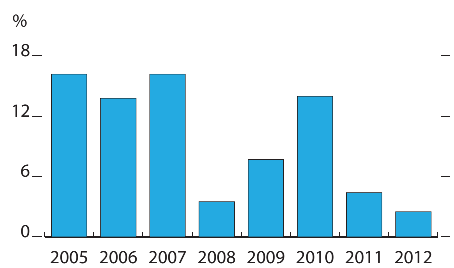
3.17.2 Fixed investment growth



Source: CEIC Data Company (accessed 23 March 2013).
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This chapter was written by Abhijit Sen Gupta of the India Resident Mission, ADB, New Delhi.

Services, which had largely held out against the slowdown in FY2011, decelerated sharply to 6.6% in FY2012, its lowest growth rate in more than a decade. This weak performance reflected the effect of the downturn on incomes, confidence, and consumer spending.

While wholesale price inflation moderated from highs in previous years, it remained elevated, averaging 7.4% in FY2012. Tight monetary policy and a slowing economy brought down inflation in nonfood manufactured goods to below 5% as the year progressed (Figure 3.17.3). However, food inflation persisted near double digits from the impact of a deficient monsoon on production and a weak farm supply response for high-protein items. Inflation based on consumer prices continued to trend at a higher level of about 10%, since food prices have a much greater weight in the index.

After maintaining a tight monetary stance to contain high inflation and inflation expectations, the Reserve Bank of India, the central bank, cut policy interest rates by 100 basis points in FY2012 to promote growth with the expectation of a less expansive fiscal policy and steps to remove impediments that have stifled a supply-side response (Figure 3.17.4). However, it cautioned against inflation risks emanating from the delayed monsoon, weak currency, and sustained wage pressures. Further, since September, the central bank has cut the cash reserve ratio by 75 basis points to 4% to alleviate liquidity shortfalls in the banking system.

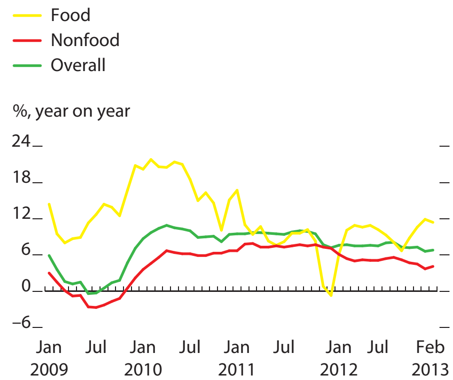
High interest rates, slackening economic activity, and slowing business and consumer demand combined to decelerate credit growth. At the same time, there was a deterioration in credit quality. Nonperforming and restructured loans are estimated to have increased to 9.5% of total loans and advances in September 2012 from 5.5% in March 2011 (Figure 3.17.5). The fall in asset quality increased banks' risk aversion and prompted portfolio switching from credit creation to investments in government securities, facilitated by large market borrowing by the government.

Despite the economic slowdown, the central government budget deficit for FY2012 was contained at 5.2% of GDP, well below the deficit of 5.7% in FY2011 but marginally above the 5.1% target. However, the quality of the fiscal consolidation is a concern. In a bid to rein in the deficit, capital expenditure was compressed and grew by only 5.8%, against the original target of 29.2%. Thus, even though the overall deficit nearly reached its target, the revenue deficit—the excess in current expenditure over tax and nontax revenue—exceeded the budgeted target by 0.5% of GDP. This reflected slippage in meeting budgeted objectives for higher tax revenues and lower subsidies.

Despite several increases in diesel prices and a cap on the number of subsidized cooking gas cylinders, petroleum subsidies were more than double the original estimates. Even food and fertilizer subsidies exceeded their budgeted targets as a weak currency increased import costs and minimum support prices for grains were raised. Consequently, subsidy payments were estimated at 2.5% of GDP, well above the target of bringing them below 2% of GDP.

On the revenue side, tepid industrial activity and stagnant imports left corporate tax and customs and excise duty collections short of their targets, though this was partly offset by higher personal income and service tax collections. Moreover, revenue from disinvestment in public sector corporations was lower than planned.

3.17.3 Inflation



Note: Based on the wholesale price index.
Source: Ministry of Industry and Commerce.
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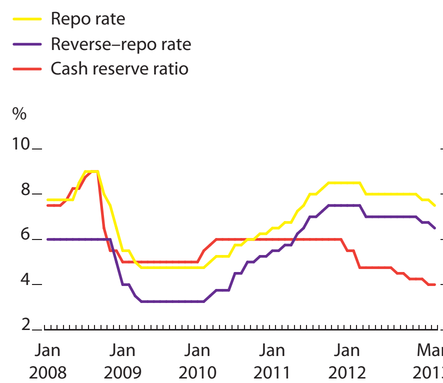
3.17.4 Policy interest rates



Source: CEIC Data Company (accessed 23 March 2013).
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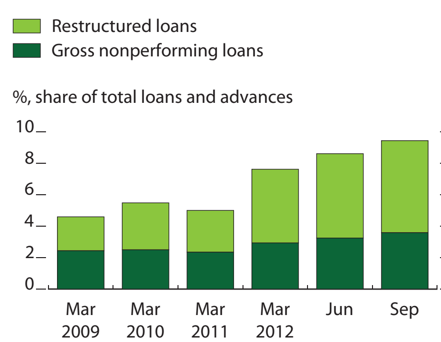
3.17.5 Nonperforming and restructured loans



Source: Reserve Bank of India http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?id=732
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The current account deficit for FY2012 is estimated at 5% of GDP, significantly higher than last year's record, driven by a deteriorating trade balance (Figure 3.17.6). Despite a weak currency, merchandise exports contracted by 4%, because of weak global demand, down to $297.4 billion. However, imports remained nearly static, declining by only 1% to $494 billion despite the slowdown in growth, largely due to inelastic oil demand and large gold imports. While in previous years the worsening trade deficit was cushioned by improvement in invisibles, FY2012 witnessed moderation in the invisibles' surplus, driven by anemic expansion in software and business services exports and remittances, and higher investment income payments.

Spurred by announcements of various reform initiatives, portfolio flows picked up in the second half of the year to reach an estimated $26 billion in FY2012. This helped the Indian rupee to strengthen after June 2012, but it nevertheless depreciated in FY2012 by 7.5% against the US dollar, and the real effective exchange rate fell by about 5% (Figure 3.17.7). The increase in portfolio investment helped to lift stock prices, with the Bombay Stock Exchange Sensex up by about 8% for the year (Figure 3.17.8). With robust portfolio investment and moderate increases in foreign direct investment (FDI) and commercial borrowing covering the current account deficit, the central bank refrained from intervening much in the foreign exchange market. Foreign exchange reserves remained broadly stable over the year at around $295 billion.

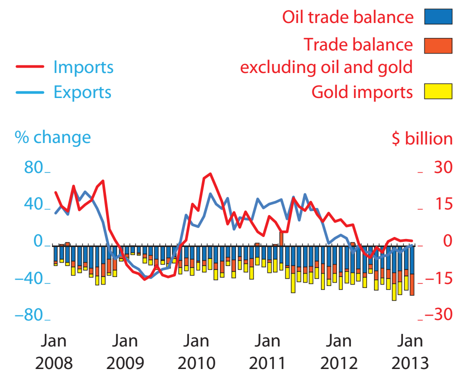
Economic prospects

The slowdown in domestic investment will need to be reversed for growth to trend upward in a sustained manner. However, recent data from the Centre for Monitoring Indian Economy on planned capital expenditures are not encouraging, as they continue to show a downward trend in announced new projects and an increase in the number of shelved projects (Figure 3.17.9). Clearly, turning this trend around will be a major challenge.

Recent reforms include the creation of the Cabinet Committee on Investment to expedite government clearances for large projects and cabinet clearance of a land acquisition bill. However, these are only first steps toward improving the investment climate, and further measures will have to be undertaken for the investment cycle to turn around. These would include tough economic and politically difficult policy decisions related to delays in environmental clearances, parliamentary approval of the land acquisition bill that involves complex issues, improving the availability of fuel sources and infrastructure linking fuel sources with power generating plants, and attaining fiscal consolidation without sacrificing capital expenditure.

Various business survey indexes present a mixed picture, indicating the need for further action to restore confidence. The central bank's business expectation index in January deteriorated in comparison with the previous year, though there was some improvement over the previous quarter (Figure 3.17.10). The latest reading of HSBC Markit purchasing managers' index for manufacturing and services is no higher than average levels earlier in FY2012 (Figure 3.17.11).

3.17.6 Trade indicators



Source: CEIC Data Company (accessed 24 March 2013).
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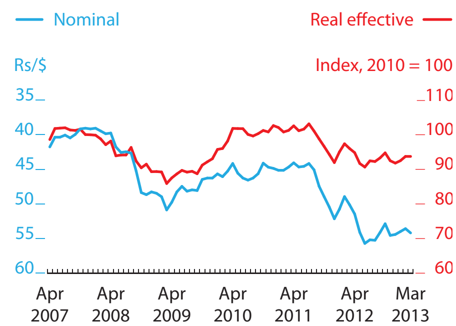
3.17.7 Exchange rates



Source: CEIC Data Company (accessed 23 March 2013).
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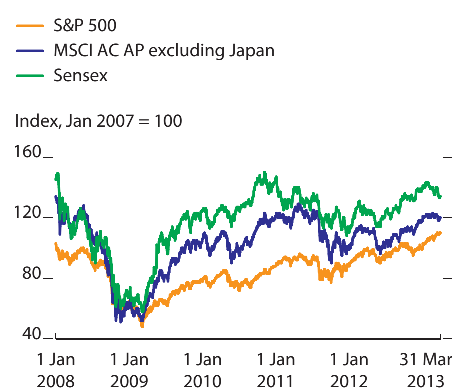
3.17.8 Stock price indexes



Source: Bloomberg (accessed 2 April 2013).
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Progress on reforms in FY2013 is expected to improve business and consumer confidence sufficiently to underpin a moderate improvement in investment and consumer spending. An upturn in global trade volume and greater budgeted government spending would further add to total demand. With results demonstrated from planned measures to reduce the budget deficit, especially progress on reducing fuel subsidies, the central bank would further ease monetary policy, which would help to sustain and build demand momentum.

A normal monsoon is expected to substantially boost agriculture growth from the depressed base a year earlier. This will strengthen rural consumer demand and ease price pressures. Industry growth should improve on better domestic and external demand, but unresolved structural issues will continue to constrain investment, mining, and power. Services are expected to see a stronger pickup in activity than industry, though growth will continue to be restrained by the limited demand. However, community services could see an uptick with increased government spending in the run-up to an election.

In this scenario, GDP growth nudges up to 6% in FY2013. Improved global prospects, some easing of price pressures, and forward movement in resolving structural bottlenecks would allow growth to increase to 6.5% in FY2014.

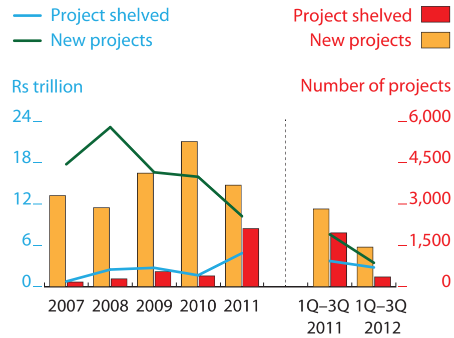
Core inflation pressures have receded considerably, reflecting the lagged impact of monetary tightening and the slowdown in economic activity. At less than 5%, core inflation is in line with the central bank's target. A normal monsoon, fiscal consolidation, and easing global commodity prices will allow some reduction in price pressures. However, some elements of wholesale price index inflation will remain sticky. Rising input costs, robust agricultural wage growth, higher minimum support prices for crops, and continuing undersupply of protein-rich products, fruits, and vegetables will keep food inflation elevated. The direct and indirect effects of the decision to allow diesel prices to be raised in a series of small steps until losses are eliminated will exert upward pressure on prices. Consequently, average inflation is expected to decline only slightly in FY2013 to 7.2%.

Inflation in FY2014 is expected to moderate to 6.8% with the effort to raise diesel prices completed and having worked through the economy, and with some forward movement in addressing supply-side bottlenecks affecting agriculture.

While monetary policy is likely to be eased further in FY2013 and beyond, as progress is made on bringing down inflation, the extent of easing will be conditioned on progress in reducing the current account and budget deficits.

The central government plans for its budget deficit to fall to 4.8% of GDP in FY2013, mainly through enhanced revenue collection (Figure 3.17.12). However, with the tax structure remaining largely unchanged, apart from higher surcharges on earnings above a threshold and higher excise and custom duties on select items, revenue targets depend heavily on growth picking up. Similarly, revenue from disinvestment and spectrum allocation is set well above the average of previous years. Meeting these magnitudes would depend on favorable market conditions.

3.17.9 New projects and projects shelved



Source: Centre for Monitoring Indian Economy.

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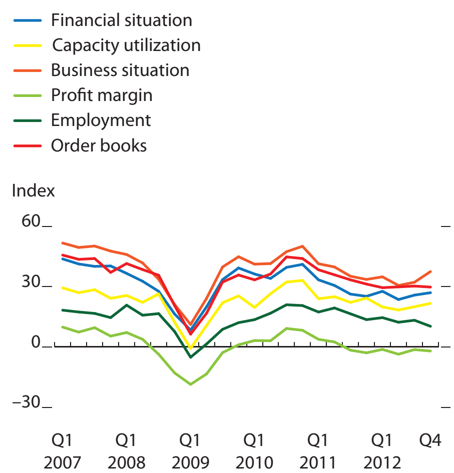
3.17.10 Industrial outlook survey



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 25 March 2013).

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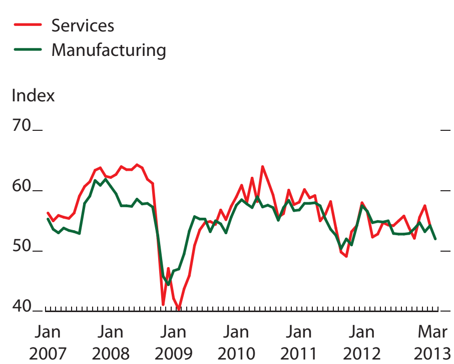
3.17.11 HSBC Markit India purchasing managers indexes



Source: Bloomberg (accessed 24 March 2013).

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Budget expenditure is set to rise sharply by 16.4% in FY2013, while subsidies are expected to fall by 10.4%. The adequacy of the allocation for subsidies depends critically on the government's willingness to continue regular revisions of diesel prices and to adjust the price of urea (Figure 3.17.13). Adverse developments from baseline assumptions on global prices of crude oil and fertilizers are risks, as is the exchange rate. Similarly, the actual requirement for food subsidies will be determined by the extent of increases in minimum support prices, the timing of the introduction of entitlements under the proposed National Food Security Act, and its scope.

Despite sluggish growth in the advanced economies, global trade volume is expected to revive and grow by 4% in 2013. The first signs of this were seen in increases in India's exports in January and February after 9 months of declines measured year on year. Given the low base and a record of taking advantage of market opportunities, exports are projected to grow by 8% in FY2013. Despite economic growth picking up marginally in FY2013, import demand will continue to be strong at 6% given India's growing dependence on imports of crude oil, coal, metals, and fertilizer. With no major improvement expected in net services and remittances, rising income payments will continue to limit the invisibles surplus. Accordingly, the current account deficit is forecast to improve to 4.4% of GDP in FY2013.

An uptick in domestic growth will boost imports by 16% in FY2014. At the same time, stronger growth prospects in the advanced economies is expected to support further expansion in exports by 14%, facilitating an improvement in the current account deficit to 3.7% of GDP.

With the current account deficit estimated to persist significantly above trend in FY2013 and FY2014, the sustainability and financing of the deficit is becoming a rising concern. The deepening dependence on debt and portfolio flows to finance the deficit has made the economy vulnerable to an oscillating risk of an on/off global macro environment and changes in sovereign ratings. Overall, the current account deficit is expected to be adequately financed by capital flows with some drawdown of reserves in case of a shortfall.

These forecasts are subject to several risks. Weak monsoons would shave agriculture growth and dent rural consumption. Delays in fiscal consolidation and slow progress in addressing some of the structural bottlenecks would damage confidence and hamper growth prospects. Finally, the global recovery continues to be weak, and significant risks arise from unresolved fiscal issues in the US and the possibility of financial shocks in euro area.

Policy challenge—financing the current account deficit

With the current account deficit breaching 4% of GDP in recent years, India has become increasingly reliant on external capital to finance the deficit. The worsening of the current account deficit has been mainly on account of a deteriorating trade deficit, which has exceeded 10% of GDP in recent years (Figure 3.17.14).

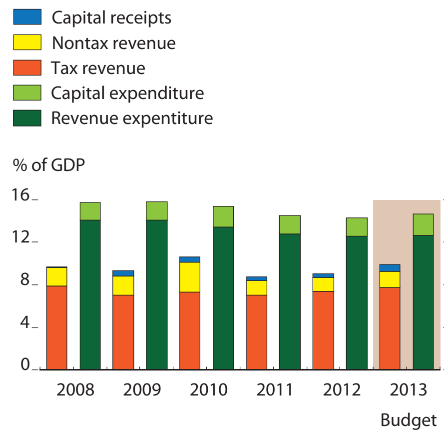
With external demand remaining tepid, exports in the near future are unlikely to grow at the robust rates experienced during FY2003–FY2007.

3.17.1 Selected economic indicators (%)

	2013	2014
GDP growth	6.0	6.5
Inflation	7.2	6.8
Current account balance (share of GDP)	–4.4	–3.7

Source: ADB estimates.

3.17.12 Fiscal indicators



Source: Ministry of Finance.
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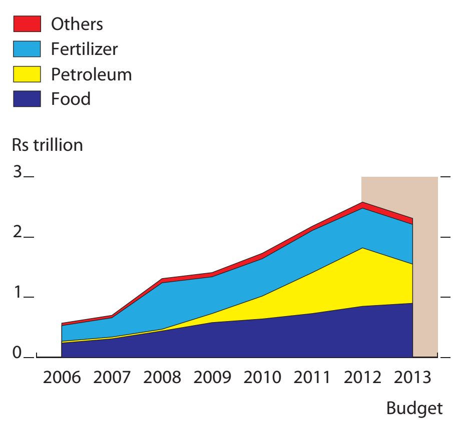
3.17.13 Subsidies



Source: CEIC Data Company (accessed 25 March 2013).
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Further, the supply side constraints and policy disarray that have stalled domestic industrial and investment activity have also hindered exports. Fiscal subsidies provide little incentive to ration demand for commodities, and structural bottlenecks hamper the production of goods such as coal, fertilizers, and iron ore, inducing growth in imports that are relatively inelastic in response to price and currency movements. Moreover, high inflation in recent years has made gold an attractive form of savings, causing imports to surge.

The invisibles surplus, which previously cushioned the trade deficit, is likely to moderate with weak recovery in advanced economies and low incremental spending on items such as software and business processing services. Investment income outflows, including interest payments, profits, and dividends, will remain elevated, reflecting the rising stock of FDI, portfolio investments, and external loans. Consequently, the current account deficit is expected to remain elevated.

Financing a high current account deficit will be a challenge in an environment of global uncertainty and sluggish domestic growth. In fact, from FY2008 to FY2012, cumulative net capital flows fell short of financing the deficit, causing reserves to stagnate (Figure 3.17.15).

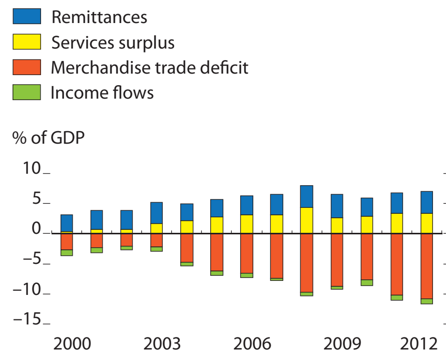
Moreover, there is concern over the pattern of financing the current account deficit, as the share of financing occupied by stable FDI inflows has fallen below 30% since the global financial crisis, from over 80% earlier. Debt flows have become the main source of financing, responding to large interest rate differentials and relaxed controls. Relaxation has included deregulated interest rates paid on the deposits of nonresident Indians, increased limits on external commercial borrowings, higher quotas for foreign investment in government and corporate bonds, and more types of long-term investors being allowed to participate in the market. Buoyed by these measures, the stock of external debt rose from $172.3.5 billion in March 2008 to $365 billion in September 2012, as short-term debt increased from 16.3% to 23.1% of total debt. While short-term debt is not excessive by conventional standards, the existence of large amounts of nonresident Indian deposits and foreign equity holdings would amplify potential damage to the economy in case of a major global financial shock or a marked weakening of domestic fundamentals.

The increasing reliance on debt flows has meant that debt service payments will rise to an annual average of $24.9 billion during FY2011–FY2015 from $16.2 billion during FY2006–FY2010. This and a high current account deficit have made India susceptible to a sovereign rating downgrade. However, recent reforms aimed at rejuvenating investment and advancing fiscal consolidation have mitigated this risk.

The high current account deficit, elevated external debt, and stagnant reserve holdings have worsened measures of reserve adequacy, though they remain robust by international standards.

Reverting to a sustainable current account deficit that can be financed by a stable mix of capital flows would require resolving the structural issues that are limiting investment and preventing a return to rapid growth that is needed to foster a dynamic export sector. At the same time, cutting the fiscal deficit will help raise domestic savings and encourage private investment. Further progress on liberalizing the FDI regime would help attract a more stable source of capital.

3.17.14 Current account components



Source: Reserve Bank of India www.rbi.org.in (accessed 18 March 2013).
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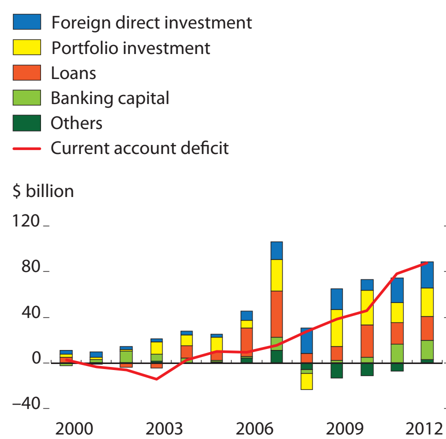
3.17.15 Financing of current account deficit



Source: Reserve Bank of India www.rbi.org.in (accessed 18 March 2013).
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