INDIA

Spurred by private consumption and investment, the economy grew strongly in fiscal 2022, albeit more slowly than a year earlier. Rising food and fuel prices pushed inflation up beyond the central bank's target. Growth will moderate slightly this year and rise next year, buoyed again by private consumption and investment as the global economy improves. Inflation will be on a downward trend as global price pressures moderate. Improving states' financial management is necessary to increase needed public investment.

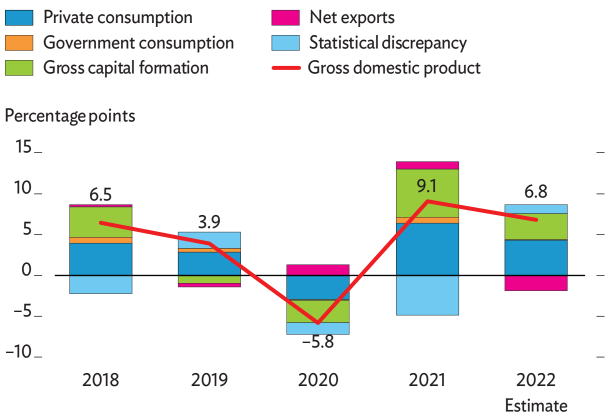
Economic Performance

The economy is estimated to have grown by 6.8% in fiscal year 2022 (FY2022, ending 31 March 2023)**.** Despite global headwinds, expansion benefited from strong growth in private consumption by an estimated 7.3%, and in investment, up by an estimated 11.2% (Figure 2.17.1). On the supply side, GDP growth was supported by agriculture, up by 3.3%, and services, up by 8.8%. Trade, hotels, transport, and communication grew robustly by an estimated 14.0%. Manufacturing growth moderated yet remained positive at 0.6%, reflecting a slowdown in global growth and high input costs (Figure 2.17.2).

Headline inflation exceeded the inflation target range of 2%–6%, averaging 6.8% in the first 10 months of FY2022. At its highest, it reached 7.8% in April 2022 (Figure 2.17.3). Global prices for oilseed, fertilizer, and fuel were elevated by the Russian invasion of Ukraine, an Indonesian ban on palm oil exports, a shortfall in global production of edible oil, and such domestic factors as disappointing wheat production and an unseasonably hot March spiking vegetable prices. These factors pushed food inflation to an average of 6.9% in the first 10 months of FY2022, while fuel inflation remained in double digits, averaging 10.6%. Inflation in both rural and urban areas was high in January 2023.

Figure 2.17.1 Demand-Side Contributions to Growth

Net exports subtracted from growth in 2022, reflecting global headwinds.



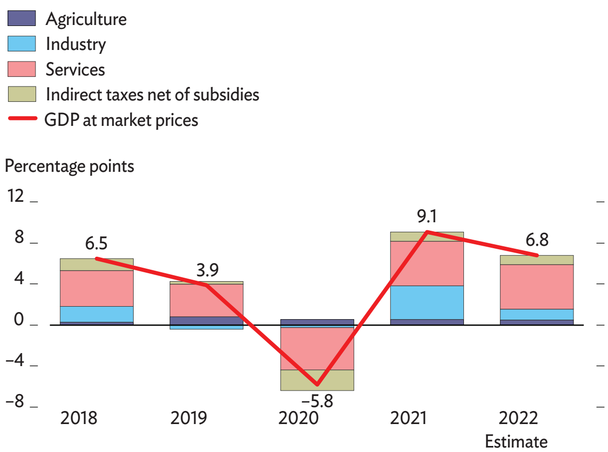
Note: Years are fiscal years ending on 31 March of the next year.
Sources: Ministry of Statistics and Programme Implementation; CEIC Data Company.

The government and the Reserve Bank of India, the central bank, undertook several measures to control inflation and its impact. The government banned exports of wheat and broken rice in 2022 to tamp down domestic price fluctuation and ensure food security. The ban on exports of broken rice was lifted in November 2022 but the ban on wheat remains.

This chapter was written by Chinmaya Goyal of the India Resident Mission, ADB, New Delhi and Shalini Mittal, former resident mission staff.

Figure 2.17.2 Supply-Side Contributions to Growth

Services continue to be the key driver of growth in the Indian economy.



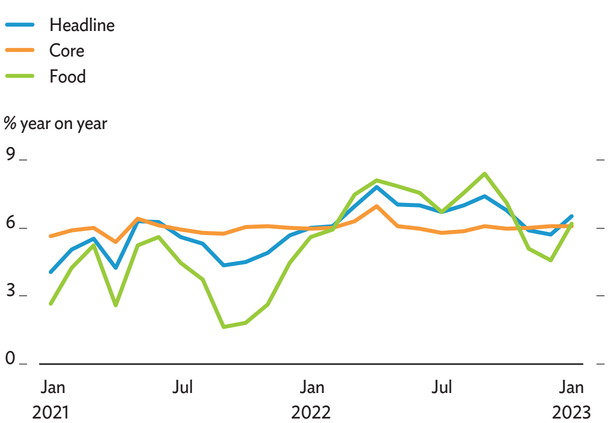
GDP = gross domestic product.

Note: Years are fiscal years ending on 31 March of the next year. Indirect taxes are imposed on production and sales, such as goods and services tax.

Sources: Ministry of Statistics and Programme Implementation; CEIC Data Company.

Figure 2.17.3 Consumer Price Inflation

Consumer inflation remained above 6.0% for most of FY2022.



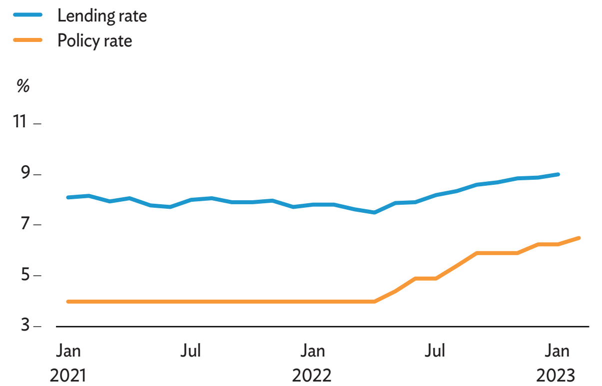
FY = fiscal year.

Source: CEIC Data Company.

Further, the government increased fertilizer subsidies by about half to ₹2.25 trillion, the highest ever from the central government. The central bank has tightened monetary policy in a series of hikes since April 2022, raising its policy rate by 250 basis points to 6.50% in February 2023, higher than the pre-pandemic rate of 5.15%. As a result, the lending rate for fresh rupee loans increased by 137 basis points from April 2022 to reach 9.00% in January 2023 (Figure 2.17.4).

Figure 2.17.4 Policy Rate and Average Lending Rate

Higher monetary policy rates to control inflation pushed up lending costs.

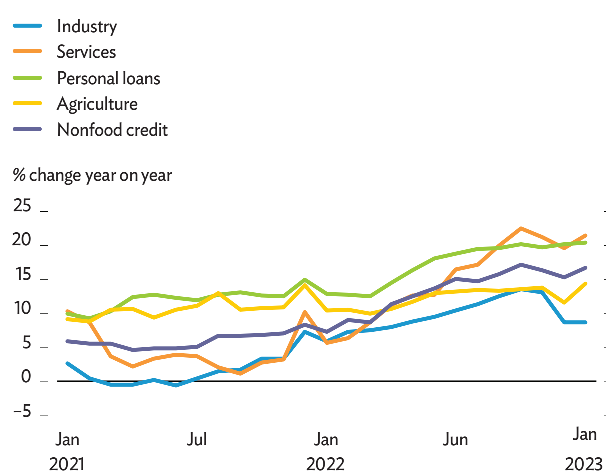


Source: CEIC Data Company.

Bank credit growth nevertheless picked up in FY2022. Excluding public sector loans for buying crops from farmers, growth in bank credit almost doubled from 8.7% year on year in March 2022 to 16.7% in January 2023, exceeding expected nominal GDP growth at 15.2%. Bank credit for agriculture and allied activities grew by 14.4% and for services by 21.5%, but for industry by only 8.7% (Figure 2.17.5). Personal loans grew by 20.4%, pushing up growth in consumption. However, continued double-digit contraction of export credit reflected weakening exports.

Figure 2.17.5 Outstanding Bank Credit

Bank credit grew, especially for services and agriculture.



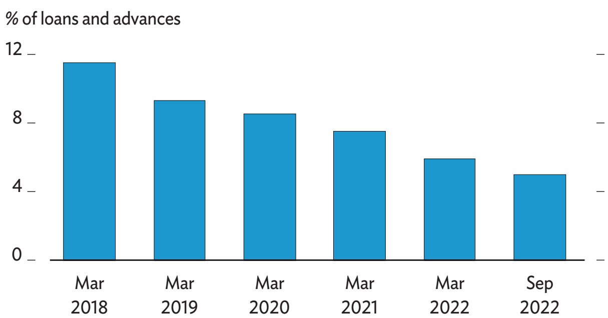
Note: Nonfood credit excludes public loans for buying crops from farmers.

Source: Centre for Monitoring Indian Economy Outlook Database.

Nonperforming loans (NPLs) declined to a 7-year low of 5.0% of all loans and advances at the end of September 2022 (Figure 2.17.6). The decline is attributed to earlier regulatory reform undertaken by the government: enacting and implementing the Insolvency and Bankruptcy Code in 2016 and reforming public sector banks starting in 2018. A publicly owned asset-reconstruction company set up in 2021 aims to reduce NPLs on banks' balance sheets by acquiring stressed assets from banks and speeding their resolution. High nominal GDP growth helped reduce corporate debt stress by accelerating growth in corporate revenue and thus making it easier for them to service debt. Stress tests conducted by the central bank indicate that NPLs may decline to 4.9% by September 2023.

Figure 2.17.6 Gross Nonperforming Loans

A fall in nonperforming loans indicates diminishing stress on banks.

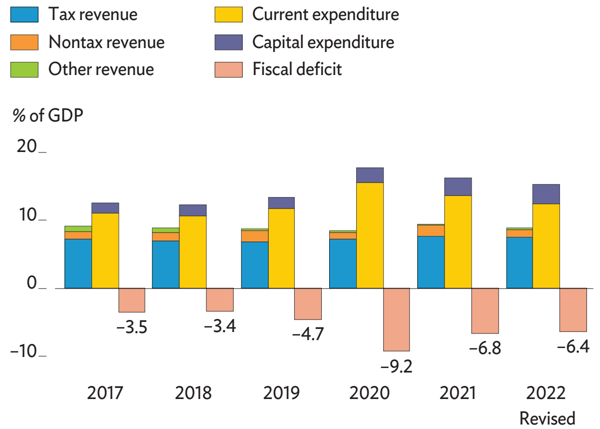


Source: Reserve Bank of India.

The central government fiscal deficit shrank from the equivalent of 6.8% of GDP in FY2021 to an estimated 6.4% (Figure 2.17.7). Central government expenditure increased in FY2022, with both current and investment outlays higher. Fertilizer subsidies were raised, and a free food distribution program was extended to protect the poor and vulnerable. Interest payments grew by 16.8% and capital expenditure by 22.8%. Expenditure cuts in areas other than energy, transport, and rural development left the government's fiscal position better than what was budgeted. Gross tax revenue is expected to greatly surpass the budget target of 2% with growth at 12.3%, which is still lower than nominal GDP growth. Tax buoyancy declined in FY2022 to 0.8, indicating a need to improve revenue mobilization. While nontax revenue fell in FY2022 by

Figure 2.17.7 Central Government Revenue and Expenditure

Reduction in current expenditure as share of GDP narrowed the deficit.



GDP = gross domestic product.
Note: Years are fiscal years ending on 31 March of the next year.
Source: Haver Analytics.

an estimated 28.3%, the government counted on asset monetization and receipts from disinvestment to balloon by 309.9% to meet its fiscal deficit target. Failure to meet disinvestment targets can widen the fiscal deficit.

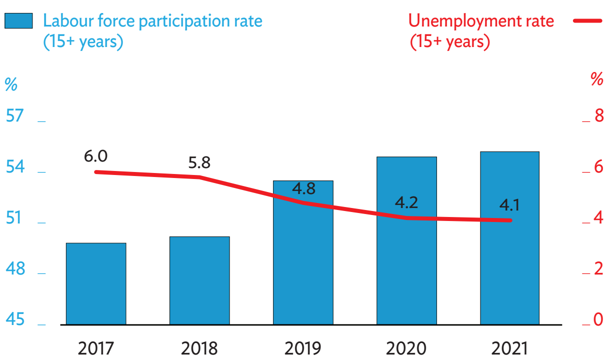
Unemployment fell to 4.1% in 2021/2022, further below the pre-pandemic rate (Figure 2.17.8). The unemployment rate improved despite an increase in the average labor force participation rate from 53.5% in 2019/2020 to 55.2% in 2021/2022, indicating improved job creation. Labor force survey data indicate that labor market conditions improved further during FY2022. Urban unemployment fell further in December 2022 and rural real wages resumed growth in November after declines in earlier months. However, the share of organized labor in employment has not increased, which could impede growth in worker productivity across the Indian economy.

The current account deficit is expected to equal 2.9% of GDP in FY2022, its widest since FY2012 (Figure 2.17.9). The main reasons are rising oil prices and a slowdown in global demand. Growth in goods exports moderated to 7.5% in the first 10 months of FY2022, slowing consistently since Q2 FY2022. The decline spanned commodities and most manufactures, reflecting slowing global demand and, later in the year, moderation in commodity prices. Exports of electronics, on the other hand, grew sharply in FY2022, reflecting the impact of India's production incentive scheme and other policy measures undertaken to induce investment into electronics. Imports of goods grew by 21.9% in the first 10 months, but growth moderated from September 2022 in line with moderation in commodity prices. As import growth outpaced that of exports, the goods trade deficit widened by 54% in first 10 months of FY2022 over the corresponding period in FY2021. The trade surplus in services, by contrast, grew by 27.7% in the first 9 months of FY2022 despite global economic uncertainty, reflecting India's continued competitiveness in services. This was helped by growth in information technology and professional services but also by reopening, which improved inbound travel and transport receipts. Remittances also grew strongly, by 28.5%, on a depreciating rupee.

Despite weaker capital inflow, foreign exchange reserves remain comfortable. Foreign direct investment inflow declined from $43.17 billion in the first 9 months of FY2021 to $36.7 billion a year later as financial conditions tightened. Foreign portfolio investment outflow in FY2022 reflected higher policy interest rates in the US and rising global tensions. The stock market had, as of 2 March 2023, yielded slightly negative returns since the beginning of the fiscal year despite being a strong performer among emerging markets since 2021 (Figure 2.17.10). The Indian rupee had depreciated by 7.4% year on year at the end of January 2023, reaching a record low of ₹83.2 per dollar in October 2022 (Figure 2.17.11). To keep the rupee from depreciating further, the central bank sold $30.5 billion in international reserves. As of end of January 2023, foreign exchange reserves worth $575.3 billion provided cover for an estimated 9.2 months of imports (Figure 2.17.12).

Figure 2.17.8 Labor Force Participation and Unemployment

The unemployment rate fell even as participation in the labor market improved.

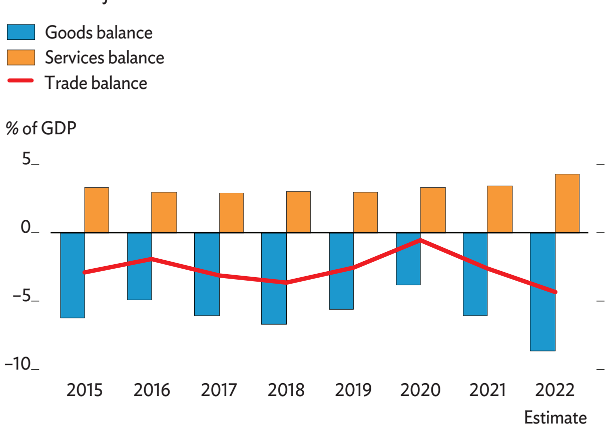


Note: Years are survey year starting in July of that year and ending in June of the following year. Estimates are for workers' usual status of employment during the year.

Source: Periodic Labour Force Survey Report. Ministry of Statistics and Programme Implementation.

Figure 2.17.9 Goods and Services Trade Balance

Despite a higher surplus in services, a widening goods deficit widened the trade deficit.



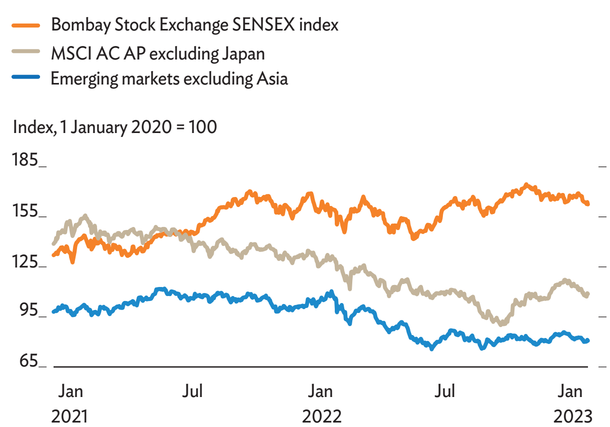
GDP = gross domestic product.

Note: Years are fiscal years ending on 31 March of the next year.

Source: CEIC Data Company.

Figure 2.17.10 Stock Prices

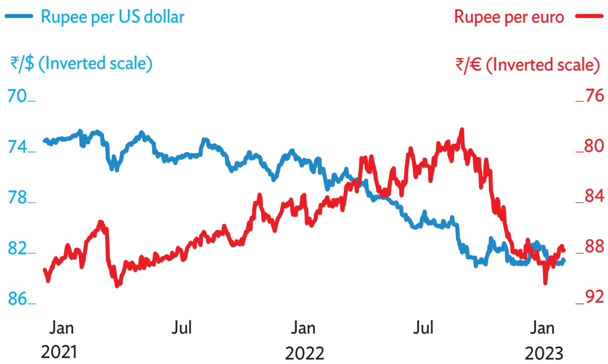
Stock prices have fallen with an outflow of global capital.



Source: Bloomberg.

Figure 2.17.11 Exchange Rate

The Indian rupee depreciated against the US dollar and euro as India's trade deficit expanded and capital inflow weakened.

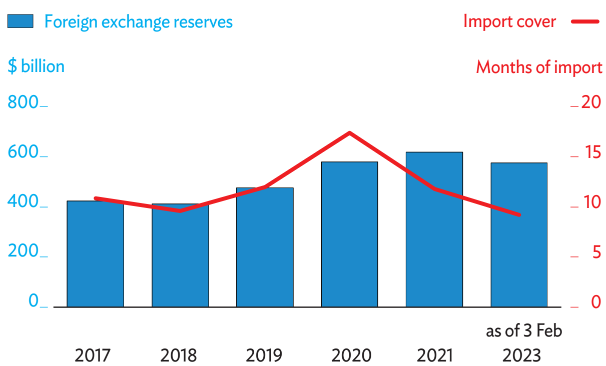


US = United States.

Source: Bloomberg.

Figure 2.17.12 International Reserves

Reserves declined in 2022 but still provided comfortable cover for imports.



Note: Years are fiscal years ending on 31 March of the next year. For FY2022, data are up to January 2023.

Source: CEIC Data Company; Reserve Bank of India.

Economic Prospects

GDP growth is forecast to slow to 6.4% in FY2023 (Table 2.17.1). The causes are an expected global economic slowdown, tight monetary conditions, and persistently elevated oil prices. The growth rate in India is stronger than in many peer economies, reflecting relatively robust domestic consumption and lesser dependence on global demand. Growth is expected to strengthen to 6.7% in FY2024 as private investment improves and growth accelerates in industry.

Table 2.17.1 Selected Economic Indicators, %

Growth will moderate in FY2023 but pick up again in FY2024.

	2021	2022	2023	2024
GDP growth	9.1	6.8	6.4	6.7
Inflation	5.5	6.7	5.0	4.5

GDP = gross domestic product, FY = fiscal year

Note: Years are fiscal years ending on 31 March of the next year.

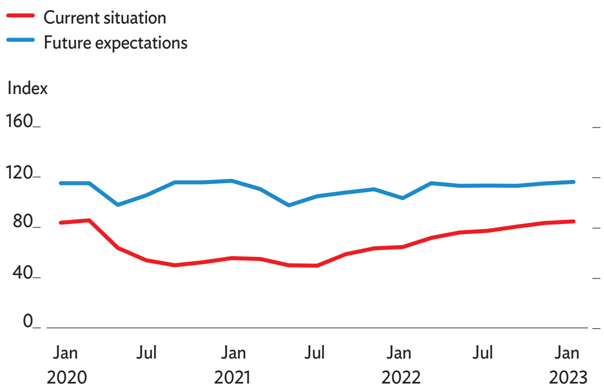
Source: Ministry of Statistics and Programme Implementation, Government of India; Reserve Bank of India; Asian Development Bank estimates.

Private consumption will be the main driver of growth. India's large domestic consumption base will mitigate the impact of a global growth slowdown. A robust labor market and rising consumer confidence are indicators of relatively strong growth in consumption in FY2023 and FY2024 (Figure 2.17.13). Further, a higher tax rebate and a raised income threshold for tax exemption, announced in the most recent budget, may increase disposable income for the middle class, also boosting private consumption. However, public consumption is likely to grow only slowly, as central government expenditure shifts toward investment. Private investment growth is likely to be lower in FY2023 given tightened monetary policy, high lending rates, global uncertainty, and moderating optimism on business conditions (Figure 2.17.14). However, FY2024 should bring fast growth in investment because of strong macroeconomic fundamentals; lower nonperforming loans in banks than in recent years, which supports banks' ability to lend; and significant corporate deleveraging, which has improved corporations' ability to borrow. Several government policies aiming to improve transport infrastructure, logistics, and the business ecosystem will induce greater private investment. However, the contribution of net exports to growth will be small as growth in both exports and imports of goods moderates in tandem with a slowing global economy, even as India's service exports remain relatively robust.

The projection for agriculture is robust growth in line with past trends. The area sown with winter crops in January 2023 was 3% higher than a year earlier. In another encouraging sign, the government increased its target for subsidized agriculture credit by 11% to ₹20 trillion. The sector will be further supported in

Figure 2.17.13 Consumer Confidence Index

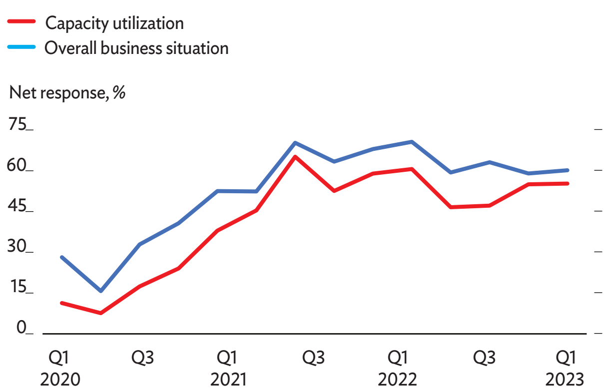
Consumer confidence improved despite higher consumer prices.



Source: Reserve Bank of India.

Figure 2.17.14 Outlook for Overall Business Situation and Capacity Utilization

Moderating business optimism can affect private investment in the short term.



Q = quarter.

Note: The figure shows the number of survey responses expressing optimism over the number expressing pessimism.

Source: CEIC Data Company.

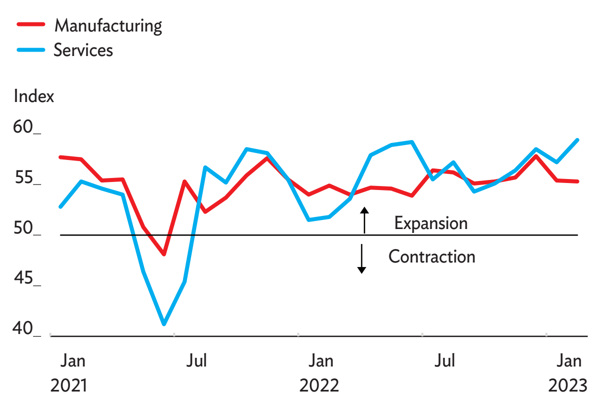
the medium term by various policies announced in the recent budget to boost agricultural productivity: setting up digital public infrastructure that provides information services for crop planning and support for start-ups and growth in the agri-tech industry.

Manufacturing growth will be sluggish in FY2023 but pick up in FY2024. It will be tamped down by weak global demand but is expected to benefit as input price inflation moderates while relatively high prices persist for outputs. Production incentives introduced in April 2021 to boost manufacturing productivity and export competitiveness have attracted investment amounting to $5.6 billion. Electronics was one of the first industries covered by these schemes and is likely to see increased production and exports this fiscal year. However, other beneficiary industries may not see significant impact on output as early as FY2023. Manufacturing growth will likely be tepid in FY2023, given the global growth slowdown, but it is seen picking up in FY2024 as expected improvement in global economic conditions lifts private investment.

Services will grow strongly this fiscal year and next as COVID-19 impacts fade away. The business outlook for services remains positive, as the purchasing managers' index for services remains in the expansion phase (Figure 2.17.15). Growth in services will be helped by recovery in tourism and other contact services as COVID-19 impacts dissipate and the share of services in domestic consumption continues to increase. Further, relatively resilient service exports despite the global slowdown will continue to boost growth in the sector. The value of transactions through the Unified Payments Interface, the public digital retail payment system, grew by 68% in FY2022 to February, further driving service growth. India's introduction of a central bank digital currency is likely to accelerate the adoption of digital payment. Nevertheless, the contribution of services to GDP growth will be lower than in FY2022 as the high base effect from normalization after COVID-19 dissipates.

Figure 2.17.15 Purchasing Managers' Indexes for Manufacturing and Services

Leading indicators for both manufacturing and services foretell strong expansion.



Source: Bloomberg.

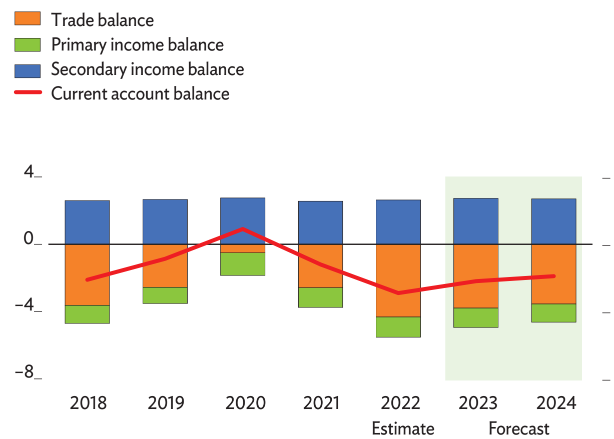
Consumer inflation is forecast to moderate to 5.0% in FY2023, assuming moderation in oil and food prices. This will bring the rate back within the monetary policy target of 2%–6%. Inflation in FY2024 is expected to slow further to 4.5% as inflationary expectations are tamped down and global inflationary pressures subside. Monetary policy in FY2023 is expected to become progressively less accommodative as core inflation, which excludes fuel and food prices, persists because of high inflation expectations and high input costs. Policy will become more accommodative in FY2024 in tandem with expected actions by the US Federal Reserve.

Fiscal policy will remain supportive of growth even as fiscal consolidation continues. The budget targets narrowing the central government's fiscal deficit to the equivalent of 6.4% of GDP in FY2022 and 5.9% in FY2023. The central government has reiterated that it is committed to bringing its fiscal deficit below 4.5% by FY2025. The projected deficit for general government, combining central and state governments, under the current fiscal consolidation plan is 7.5% of GDP by 2025, down from 10.4% in 2021. India's public debt is on a sustainable path. After general government debt increased from 75% of GDP in 2019 to 89% in 2020 as the authorities responded to the pandemic, it declined to 84% in FY2022 and is expected to continue to decline gradually over the medium term. As it undertakes fiscal consolidation, the central government will still increase capital spending to support growth. This is important because capital spending is especially effective in India at spurring overall demand. Increased capital spending by the states is also important to garner more growth from public capital expenditure. However, the ability of states to contribute may be stymied unless their financial vulnerabilities are addressed (see below).

The current account deficit will likely moderate to the equivalent of 2.2% of GDP in FY2023 and 1.9% in FY2024 (Figure 2.17.16). It will narrow with moderation in global oil prices below $100 per barrel. Growth in goods exports is forecast to moderate as well in FY2023 as global demand slows and then improve in 2024 as production incentive schemes improve performance in electronics and some other areas of manufacturing. Growth in exports of services, while also likely slower than in FY2022, is expected to outpace goods exports, given India's competitive advantage in information technology services. Growth in imports of goods and services is expected to slow as commodity prices moderate, narrowing the trade deficit. With rising global uncertainty and interest rates, foreign direct investment and portfolio inflow are likely to remain weak in FY2023 before picking up slightly in FY2024 (Figure 2.17.17). Nevertheless, India's overall balance of payments will remain strong to the forecast horizon.

Figure 2.17.16 Current Account Balance

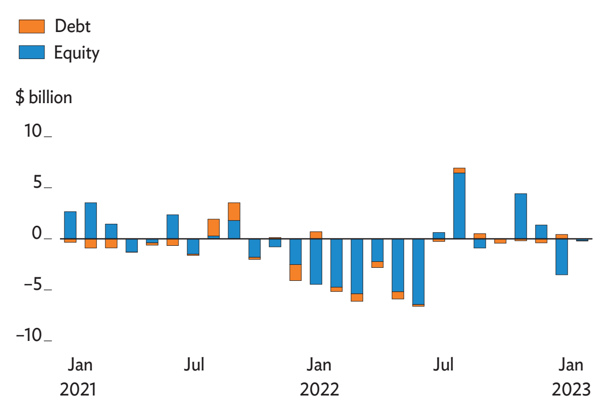
An improving trade balance will narrow the current account deficit in FY2023 and FY2024.



FY= fiscal year.
Note: Years are fiscal years ending on 31 March of the next year.
Sources: CEIC Data Company; Asian Development Bank estimates.

Figure 2.17.17 Net Foreign Portfolio Investment Flows

Foreign portfolio inflow will continue to be weak as global economic uncertainty persists.

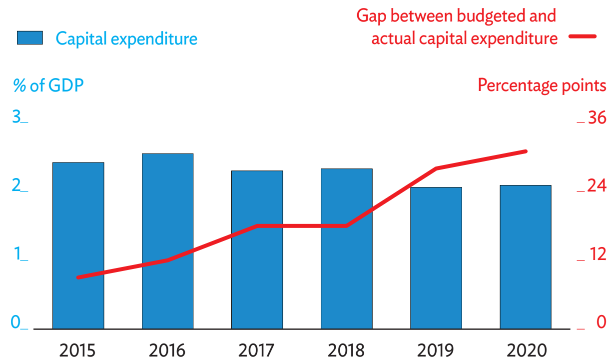


Source: Security and Exchange Board of India.

Risks to the growth outlook arise from both global and domestic factors. If global conditions do not deteriorate as much as anticipated, higher global demand will likely spur growth in India. However, any worsening of geopolitical tensions is likely to exert further downward pressure on global demand and increase uncertainty, tamping down India's growth rate and pushing up inflation. Domestically, weather shocks to agricultural production, including abnormal rainfall or higher temperatures, could spur food inflation, thereby putting further pressure on the central bank to raise interest rates.

Figure 2.17.18 State Capital Expenditure, Budgeted and Actual

States capital expenditure has fallen as a share of GDP in recent years.



GDP = gross domestic product.

Note: Years are fiscal years ending on 31 March of the next year.

Source: Reserve Bank of India. 2023. State Finances: A Study of Budgets of 2022-23.

Policy Challenge—States' Quality of Expenditure and Off-Budget Borrowing

India needs higher public investment in infrastructure, urban development, health, and education, but individual state investment has been weak. States are an essential part of India's fiscal architecture and responsible for a majority of general government expenditure. The central government has raised expenditure on infrastructure and health care, but states have not followed suit. Capital expenditure by states fell from 2.6% of GDP in FY2016 to 2.1% of GDP in FY2020. At the same time, a significant gap exists between budgeted and actual capital expenditure, with 9% of budgeted capital expenditure unspent in FY2015, rising to 28% in FY2019 and 31% in FY2020 (Figure 2.17.18). Excluding union territories, the widest capital expenditure gaps exist in Andhra Pradesh, Bihar, Punjab, and West Bengal.

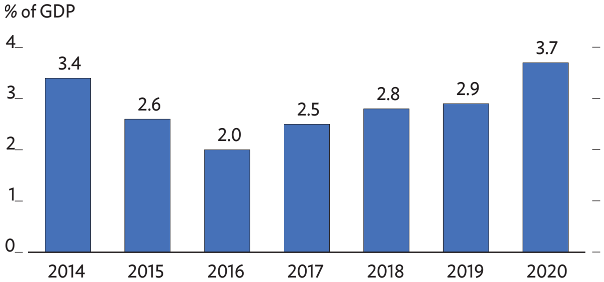
Lower capital expenditure occurs as revenue falls short of the budgeted amounts and other spending is prioritized. Even before the pandemic, state revenue had fallen from the equivalent of 13.6% of GDP in FY2017 to 13.3% in FY2019, with own tax revenue falling by 0.5 percentage points. State finances have been affected as well by high expenditure on such nondiscretionary items as interest payments, salaries, and pensions, and by priorities accorded to subsidizing electricity, water supply, and various other services.

Rising off-budget vulnerabilities and other contingent liabilities frustrate efforts to improve states' capital expenditure. In most states, fiscal responsibility and budgetary management legislation aims to keep the fiscal deficit below the equivalent of 3% of GDP. In the pre-pandemic period of 2014–2019, the average state fiscal deficit equaled 2.7% of GDP. However, states also borrow off budget and therefore beyond the reach of the legislative framework. Off-budget liabilities occur when public sector entities borrow on behalf of the state governments with the expectation of debt being serviced through the state budgets. States may face other contingent liabilities when public sector entities borrow more than they can service on the strength of a sovereign guarantee, explicit or implicit, which may require state intervention. Off-budget and other contingent liability amounts covered by explicit guarantees issued by states fell in FY2015 and FY2016 but increased from the equivalent of 2.0% of GDP in FY2016 to 3.7% in FY2020 (Figure 2.17.19).

Electricity supply accounts for most contingent liabilities and typifies the fiscal risks to states. Because of consistent financial losses suffered by several state electric power distribution companies (DISCOMs) and their accumulated debt, state governments took over DISCOM liabilities under a central government scheme launched in 2015. This lowered contingent liabilities in FY2015 and FY2016 but added to state government debt and interest payments. Meanwhile, DISCOM losses have continued, piling up outstanding debt. This will likely affect states'

Figure 2.17.19 Outstanding Guarantees of State Governments

Outstanding guarantees issued by state governments increased.



GDP = gross domestic product.

Note: Years are fiscal years ending on 31 March of the next year.

Source: Reserve Bank of India.2023, State Finances: A Study of Budgets of 2022-23.

fiscal positions, especially as newly proposed reform by the central government entails state budgets absorbing the financial losses. Whether remaining as contingent liabilities or brought on budget, the guarantees provided by state governments inhibit their ability to undertake needed public investment.

Addressing this problem requires comprehensive reform. Efforts to improve states' resource mobilization are required to enhance resource availability. This could be achieved by enhancing either tax revenue through better tax design and administration where controlled by the states, such as the property taxes, or nontax revenue such as user fees for services provided by states. States need to improve budget transparency by including all off-budget borrowing and planned spending into their budgets. They should also reform electricity supply to improve the financial management of DISCOMs, reduce leakage, and enhance their financial viability. This would include revising electricity tariffs, installing robust metering systems to prevent revenue leakage, strengthening distribution systems, institutional and governance reform, and introducing private sector competition where feasible. Further, states should prioritize productivity-enhancing investment in physical and human capital over popular subsidies and income transfer schemes.