India

GDP growth slowed markedly in FY2011 as industrial and investment activity slumped and the current account deficit widened. A combination of tight monetary policy to counter persistently high inflation, strained global economic conditions, larger subsidies that pushed up the budget deficit, and lack of political consensus on resolving the policy impediments to growth were factors in the downdraft. Boosting investment and growth to match the strong performance of recent years will hinge on reaching agreement on measures to deal with long-standing and challenging policy issues. The outlook is for a moderate pickup.

Economic performance

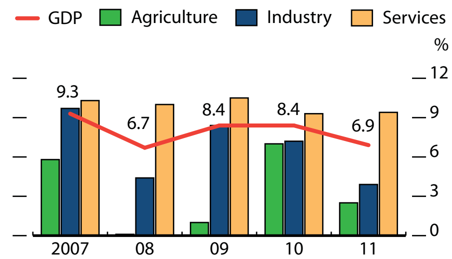
Economic growth fell to 6.9% in FY2011 (ended 31 March 2012) from 8.4% in FY2010 according to the government's advance estimates. The pace slowed as the year progressed (Figure 3.17.1). The slowdown was concentrated in industry and driven by slumping investment activity, falling exports in the latter months, and attendant weakening in consumer spending.

Investment growth recovered quickly from its low point in the depths of the global financial crisis, although the trend reversed once more to a marked decline over the past 2 fiscal years (Figure 3.17.2). Notably, in the first 3 quarters of FY2011, fixed investment is estimated to have fallen by 0.25% from the corresponding period a year earlier, although the government's advance estimates of GDP for the full fiscal year show an increase of 5.6%.

However the final data for the year turn out, the downward trend is evident—as is the need to reverse it to get the country back on its recent-year high growth path. The causes of investment's sharp deceleration are multiple, including the slump in the global economy and trade, tighter monetary policy and higher nominal interest rates (to combat persistent high inflation), a larger than expected budget deficit in FY2011 (adding to uncertainty over the direction of the economy), and a growing sense of a national policy paralysis (due to political parties' inability to agree on certain issues, including structural measures).

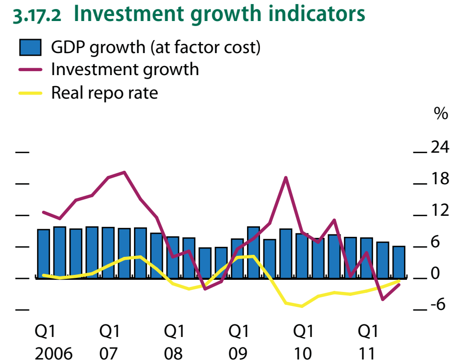
Industrial growth dropped to a decade-low 3.9%. Slumping investment took its toll: manufacturing growth fell by half to 3.9%, largely reflecting weak capital goods output, and construction growth fell to 4.8% from 8.0% a year earlier. In industry, mining contracted by 2.2%, partly due to uncertainty over land and environmental clearances. Coal production continued its slowing-growth trend of recent years, shrinking by 1.5%. The controlling state monopoly is unable to ramp up production to meet rapidly growing demand from new power plants, thereby increasing reliance on more costly imports. Natural gas production fell by 8.8%, owing to technical problems at a large new field and pricing issues.

3.17.1 GDP growth by sector



Source: Ministry of Statistics and Programme Implementation.

3.17.2 Investment growth indicators



Source: CEIC Data Company (accessed 24 March 2012).

This chapter was written by Abhijit Sen Gupta of the India Resident Mission, ADB, New Delhi.

On a brighter note, services continued to grow rapidly, at 9.4%, accounting for nearly 80% of overall GDP growth and reflecting continued strong performance in trade, hotels, transport, communications, and financial services. With good monsoons, rice and wheat production is estimated to have hit records. Agriculture's 2.5% expansion was low compared with the previous year's weather-related 7.0% recovery, but still came in close to trend (3%).

Inflation, which persisted at 9.5–10% through most of FY2011 despite earlier rounds of monetary tightening, eased to 7.0% by February 2012 (Figure 3.17.3). This moderation largely reflected a drop in food prices. A proxy for the core rate, nonfood manufactured goods inflation remained at around 8% then fell to 5.5% in February 2012. Since monetary tightening aimed to stabilize this measure, the central bank has seen progress in bringing it down to its historical average of 4%, consistent with maintaining stable inflationary expectations.

After 13 consecutive policy rate hikes since March 2010, the Reserve Bank of India (RBI) left rates on hold at its December 2011 and February 2012 policy review meetings (Figure 3.17.4). With progress on slowing nonfood inflation, as of late-March 2012 it was expected to relax monetary policy for the new fiscal year when the deficit-reduction measures announced in the FY2012 budget in mid-March are passed by Parliament.

Credit growth moderated in FY2011 across a broad spectrum of activities, reflecting slowing economic activity, monetary tightening, and banks' risk aversion. Asset quality of banks deteriorated moderately due to weaker business conditions.

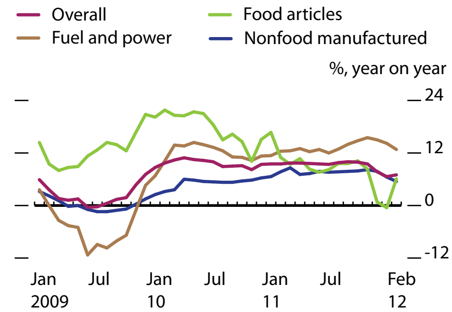
The RBI deregulated the savings deposit rate—allowing banks to set differential interest rates on savings deposits over a minimum amount—and, to a large degree, interest rates on the various nonresident Indian deposit facilities.

A revenue shortfall and expenditure overshoot, relative to target, pushed the central government budget deficit to an estimated 5.9% of GDP in FY2011, as against the 4.6% budget target. Revenue was down by 3.3% from the previous year when it was bolstered by large receipts from auctions of third-generation telecommunications spectrum. It was also 5.7% short of target, about equally due to a shortfall in the planned sale of government-held stock in public sector corporations because of weak stock market conditions and to the economic slowdown denting tax collections.

Expenditure grew by 10.1% in FY2011 and was nearly 5% above the budget target, mainly owing to greater subsidies. Higher global prices and a weaker currency led to an increase in fuel (190%) and fertilizer (34%) subsidies, while higher minimum agricultural support prices helped raise the cost of food subsidies (20%) over the budget targets. All these subsidies amounted to 2.3% of GDP in FY2011.

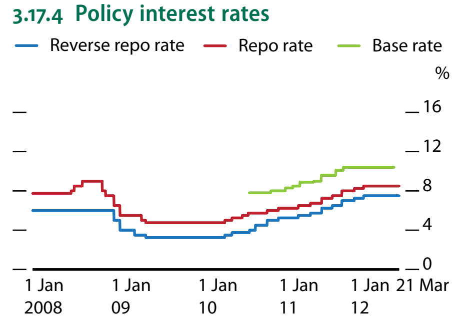
The current account deficit widened to an estimated 3.6% of GDP (Figure 3.17.5). The very rapid growth in exports in the first half of FY2011 was not sustained in the second owing to slowing demand from advanced economies, restricting growth to 21.0% at $303 billion. Higher commodity prices and an increase in import volume, including large imports of gold, generated a 24.0% rise in imports to $473 billion, expanding the trade deficit to 9.1% of GDP (from 7.6% in FY2010), partly offset by a strong services trade surplus and larger remittances.

3.17.3 Wholesale price index



Source: Ministry of Industry and Commerce.

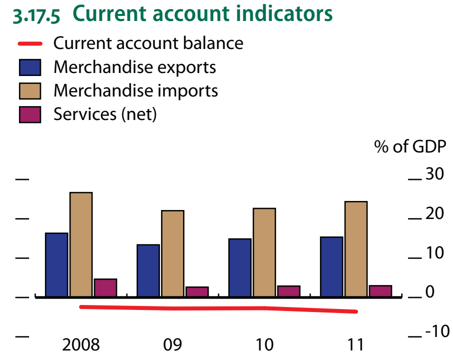
3.17.4 Policy interest rates



Note: The base rate was adopted to provide an accurate indicator of the minimum rates charged to prime borrowers.

Sources: CEIC Data Company (accessed 27 March 2012); ADB estimates.

3.17.5 Current account indicators

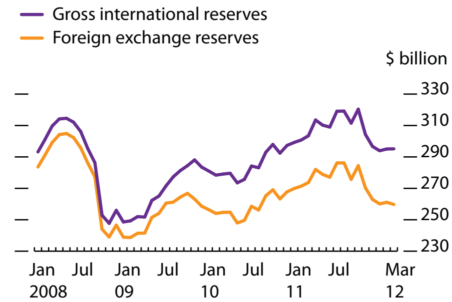


Source: Reserve Bank of India.

The heavy current account deficit was mostly financed by financial inflows. With concerns over sovereign debt and fiscal prospects in the United States and eurozone, net portfolio inflows were slight for much of the year but picked up after November to reach an estimated $15 billion in FY2011, about half that of a year earlier. Improved foreign direct investment (FDI) and larger commercial borrowing and bank loans by the private sector rounded out the financing.

Official gross international reserves fell by about $10 billion (to about $295 billion), mainly in the latter months of the year (Figure 3.17.6) on intervention by the RBI to prevent excessive downward drift (and volatility) in the exchange rate. Over FY2011, the rupee depreciated by about 12% against the US dollar; the real effective exchange rate weakened by about 4% (Figure 3.17.7). Stock market prices drifted lower for most of FY2011 and then strengthened in early 2012, helped by a marked increase in portfolio investment. Nevertheless, the BSE Sensex was down about 10% in FY2011.

3.17.6 International reserves



Note: Gross international reserves include gold and SDRs.

Source: Reserve Bank of India. http://www.rbi.org.in (accessed 27 March 2012).

Economic prospects

Investment is likely to remain lackluster for some time because new project announcements continued to decline during the third quarter of FY2011 (Figure 3.17.8). Data on planned capital spending from the Centre for Monitoring Indian Economy also point toward a sharp increase in the number of stalled projects, reflecting a host of structural bottlenecks related to fuel and power shortages, delays in environmental clearance, and other policy hurdles.

Business sentiment has deteriorated on various indicators in the RBI's Business Expectation Index (Figure 3.17.9), and in similar surveys conducted by chambers of commerce. On balance, these business indicators suggest that investment will remain subdued in FY2012.

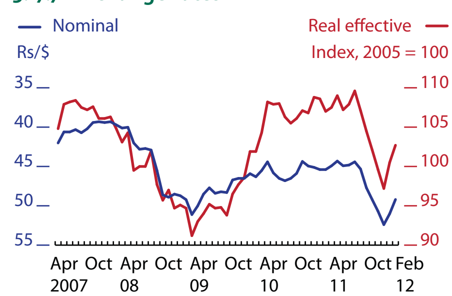
The impact of monetary easing and lower interest rates, improving external conditions, and some progress on stalled reforms and removal of the bottlenecks should lead to a revival of industrial activity starting in the second half of FY2012 and into FY2013. But their effect is likely to be limited until the government eliminates the policy issues. Recent steps, such as increasing the pace of road building as well as fast-track clearances for coal and power projects, are encouraging, though many other issues remain in the wings.

A normal monsoon would help agriculture expand at its trend rate (around 3%), in turn bolstering rural incomes and private consumption. The services sector, which has so far been resilient to the domestic slowdown, is expected to maintain its solid growth, supported by robust trends in private consumption spending and in urbanization. The global slowdown is, however, likely to trim growth in software and business services.

Based on assumptions for growth in industrial countries and oil prices, as well as expected moves toward monetary easing coupled with budget deficit reduction, GDP growth in FY2012 is forecast to nudge up to 7.0%. Recovery in the global economy and resolution of some of the structural bottlenecks are expected to increase GDP growth to 7.5% in FY2013.

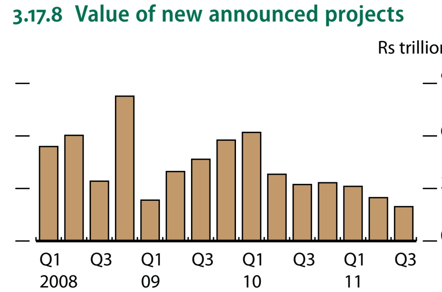
Sustaining the progress against inflation in FY2012 depends on macroeconomic policies and structural reforms. Much of the past

3.17.7 Exchange rates



Source: CEIC Data Company (accessed 27 March 2012).

3.17.8 Value of new announced projects



Source: Centre for Monitoring Indian Economy. 2011. *Monthly Review of the Indian Economy*. March 2012.

2 years' inflation stemmed from increases in the prices of high-protein foods, fruits, and vegetables rather than foodgrains. With rising incomes, demand has increased faster than supply for these, thus agricultural policies will need to be directed to improving the efficiency of the regulatory, production, and distribution systems. There is also considerable suppressed inflation, as the administered prices of diesel, kerosene, and liquefied petroleum gas—significantly below global oil prices—require heavy budget subsidies. Adjusting domestic prices will push up inflation but is necessary to align fiscal policy with the needs of expanding infrastructure investment.

Inflation is expected to continue to decline in FY2012 due to the strong base effect, normal monsoons in FY2011, weakening global commodity prices, and lagged impact of monetary policy on expectations suppressing demand-side inflation. Consequently, inflation is expected to ease to 7.0% in FY2012. The rate in FY2013 will depend on tackling structural food price pressures and the extent of fiscal consolidation, as FY2013 is a pre-election year. An easing of crude oil prices and supply-side bottlenecks is likely to contribute to inflation falling further to 6.5% in FY2013.

Increasing tax rates, widening the tax net, and capping the subsidy bill are expected to reduce the fiscal deficit to 5.1% of GDP in FY2012, signaling a return to fiscal consolidation (Figure 3.17.10). The increase in excise duty and service tax from 10% to 12% as well as the introduction of a negative list for the service tax is expected to take revenue growth to 23%. However, the actual realization of revenue from asset sales, such as disinvestment of publicly owned companies and auction of telecom spectrum, which are expected to generate 0.7% of GDP, will crucially depend on market conditions.

The budget has expenditure rising moderately by 13.1% and subsidies falling by 12.2%—fuel's by 36.3% (Figure 3.17.11). These targets seem optimistic, given elevated oil prices and the limited pass-through to domestic retail prices.

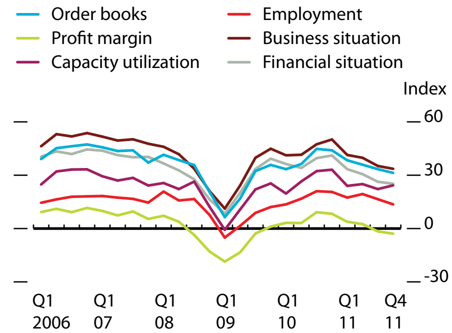
Still-high global oil prices and softening external demand will continue to exert pressure on the current account deficit in FY2012. However, sluggish investment and industrial activity will help damp non-oil import growth. Moreover, gold imports, which boosted imports in FY2011, are expected to be trimmed by a higher tax this year. Overall, imports are expected to grow by 15% in FY2012.

Moderation of growth in the advanced economies will adversely impact exports as well as receipts on account of software and business services. Export growth is forecast to slip to 14.0% in FY2012. Remittances are expected to show strong growth as banks are now free to set rates in response to market forces. The current account deficit is forecast to improve marginally to 3.3% of GDP in FY2012.

Improved economic prospects in the advanced economies are expected to boost export growth to 19.0% in FY2013. At the same time, an uptick in domestic growth will increase import demand, leading to imports growing by 18.0%. Strengthening economic activity in the advanced countries is seen encouraging services exports, leading to the current account deficit moderating to 3.0% of GDP in FY2013.

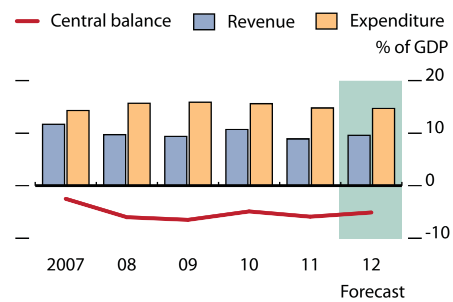
Portfolio investment is expected to be relatively volatile, and be influenced by the extent of investor risk aversion, global liquidity, and

3.17.9 Industrial outlook survey



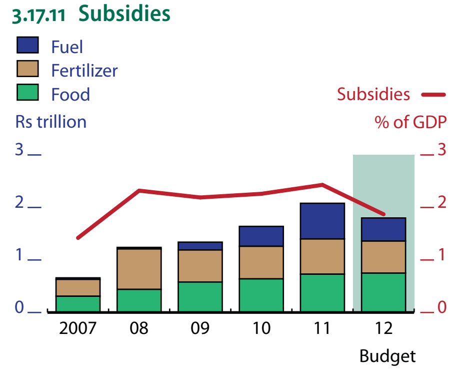
Source: Reserve Bank of India. http://www.rbi.org.in (accessed 20 March 2012).

3.17.10 Central government budget indicators



Source: Ministry of Finance. http://indiabudget.nic.in (accessed 18 March 2012).

3.17.11 Subsidies



Source: Ministry of Finance. http://indiabudget.nic.in (accessed 18 March 2012).

improvement in domestic fundamentals. FDI is likely to increase only modestly; however, external borrowings are set to remain healthy given the interest rate differential with advanced economies. The current account deficit is expected to be financed by capital flows.

The above forecasts are subject to a number of risks. The global environment remains fragile and a worsening of the situation in the eurozone would have a significant adverse impact. A poor monsoon, fiscal slippage, or a continued policy logjam to resolve some of the long-standing issues would also prove detrimental to growth.

3.17.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.0	7.5
Inflation	7.0	6.5
Current account balance (share of GDP)	-3.3	-3.0

Source: ADB estimates.

Policy challenge—attracting FDI

In view of the large investment needs of the economy, especially infrastructure, a reasonable current account deficit is appropriate, notwithstanding India's high savings rate. The government's clear preference is for the deficit to be financed by equity flows rather than debt flows and for FDI over volatile portfolio flows.

FDI has increased in recent years from the 1990s' negligible levels, but remains small relative to comparable destinations: according to UNCTAD's *World Investment Report 2011*, in 2010 it came to only $24.6 billion, compared with $105.7 billion for the People's Republic of China, $48.4 billion for Brazil, and $41.2 billion for the Russian Federation (Figure 3.17.12).

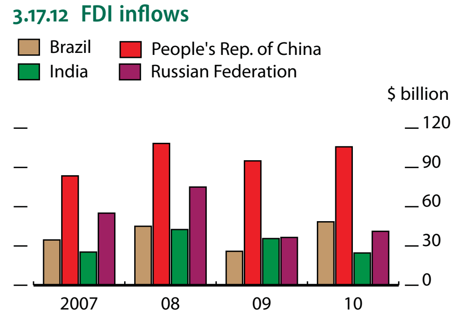
A key issue confronting FDI is acquisition of land for economic activity as it involves a number of complex issues. These include use of agricultural land for non-agricultural purposes, adequate compensation, displacement of people—including indigenous tribal populations—and the dichotomy between state and center laws, which in many cases has impeded investment. The Land Acquisition, Rehabilitation and Resettlement Bill, introduced in Parliament in 2011, addresses some of these issues, although reaching a consensus among the various stakeholders is likely to be arduous.

Environmental issues such as high ecological costs and concerns about tribal rights have held up some foreign projects. In mining, for example, securing licenses and clearances has become contentious, given that most mineral deposits are in forested areas, home to the country's indigenous tribes. The draft Mining and Minerals Development and Regulation Bill is deemed by the industry as taxing it too heavily. Similarly, government initiatives, like guidelines for the Comprehensive Environmental Pollution Index and demarcation of stretches of ecologically sensitive coastline, need to ensure that they do not deter investment in critical sectors.

Certain elements of labor laws deter investment, and need to be revisited if India is to attract FDI into labor-intensive manufacturing. The need for labor market reforms has been long recognized by policy makers but the issue is highly fraught, lacking the necessary political support for change. Weak infrastructure, especially in the areas of transport, power, and education and training, has also reduced India's attractiveness to FDI.

Finally, inconsistent policy making can also damp investor confidence by raising transaction costs and uncertainty about the business environment. Reducing the number of clearances and introducing single-window nodal agencies can help to remove regulatory hurdles and fast-track projects.

3.17.12 FDI inflows



Source: United Nations Conference on Trade and Development. *World Investment Report 2011*.