

A Passage to India: Towards Robust Economic Growth?

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Summary

- The outlook for the Indian economy over the next two years looks promising. Confidence is high, capital is flowing in again and the monsoon arrived on time. India's economy is now less prone to volatility linked to poor harvests or balance of payments crises – problems that plagued it in the past.
- Manufacturing has led the recovery but the key driver of growth remains services, which represents nearly 60% of the economy.
- Services exports make up almost 40% of total exports and about 10% of GDP. World trade in services suffered less than goods during the recession and this cushioned India's growth and balance of payments.
- The upshot is that India should see growth of about 8-8.5% this year and 7-8% next.
- Nevertheless, there are a number of constraints to growth that need to be resolved, including inflation, the fiscal deficit and infrastructure bottlenecks. The government is trying to address these problems and to re-start the reform programme to free up the economy.
- If these reforms prove successful, India can expect longer-term growth nearer the top of the 7-9% range, only a shade lighter than China. However, even if such progress is slow, the dynamic services sector is probably capable of delivering GDP growth as high as 6-7%, far better than India's norm of a decade ago.

Number 44 (September 2010)

International Series number 11

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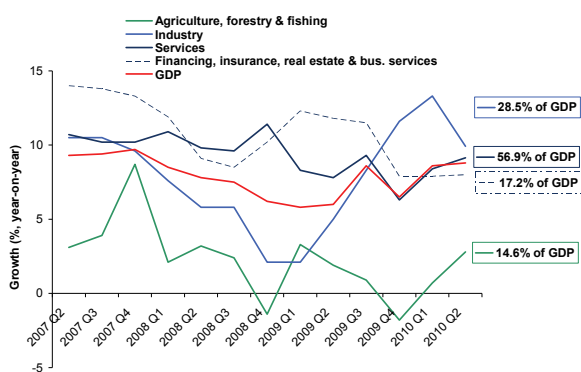


CII Introduction: the following article examines the various trends underway within India's burgeoning economy, from sturdy services and manufacturing growth to worries about farm output, inflation, infrastructure bottlenecks and progress on reforms. The problems as well as the successes are explored to assess the risks to the economic outlook. On balance, this analysis points to further strong growth ahead.

India has proved its resilience over the last two years but was not entirely immune to the global crisis. Total GDP growth slowed from a rapid 9%+ in 2007 immediately before the crisis to around 6% at the end of 2008 and into the first half of 2009 but the economy has since bounced back in the last year to enjoy growth of around 8.5% in the first half of 2010.¹

It is nevertheless important to unpick the headline numbers for the economy as there are different trends across sectors. Agricultural output was hit by poor monsoon rains in 2009 but should do well this year. Manufacturing also took a hit early in the crisis as the savage operation of the stock cycle worldwide led to a sharp cutback in export orders. In the last nine months however, as confidence has returned to the sector, manufacturing has powered ahead taking over the baton from services as the economy's growth engine. Financial and business services also slowed slightly in the crisis but picked up again in 2009 before easing back in the first half of 2010. Construction was booming before the crisis, then slowed down for a year as uncertainty gripped markets before picking up again in the last nine months.

Figure 1: GDP Growth by Sector (year on year)



Source: Indian Ministry of Finance

¹ For an analysis of the longer term prospects of India and its influence on the rest of the south east Asia, see for example [The Southern Surge: Prospects for Insurance and Financial Services in India and South East Asia](#), a CII report by Vanessa Rossi of Chatham House, July 2010. Both the report and an event webinar are available at www.cii.co.uk/research

India's exposure to the financial crisis

To some extent, sectoral variations offset each other during the crisis, enabling the Indian economy to maintain steady growth. There were a number of channels through which these sectoral variations worked in India's favour:

1. Limited dependence on exports

Although India's economy has become more open to world trade in recent times, it still remains less dependent on exports than its neighbours (Table 1). A fall in foreign demand therefore has had relatively less of an impact on India's economy.

Table 1: Exports as proportion of GDP in Selected Asian countries

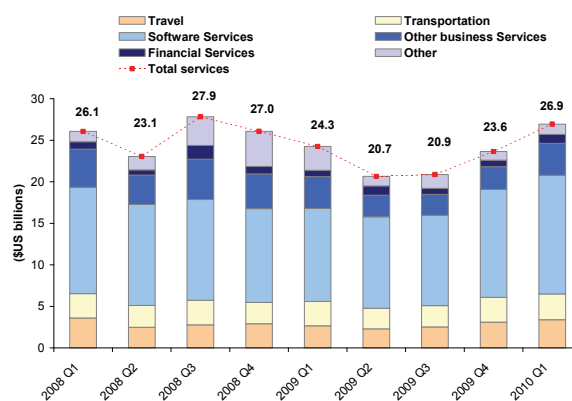
	Exports as % of GDP 2008
India	23.8
China	36.6
Korea	54.8
Taiwan	76.5
Thailand	76.6
Malaysia	103.9

Source: IMF and Taiwan National Statistics

2. Services exporter

Another reason for India's relative stability is its mix of exports. Nearly 40% of India's exported products are services, which is significant as this trade has been much less adversely affected by the financial crisis than manufacturing (Fig 2).

Figure 2: Services exports (quarterly, \$billion)

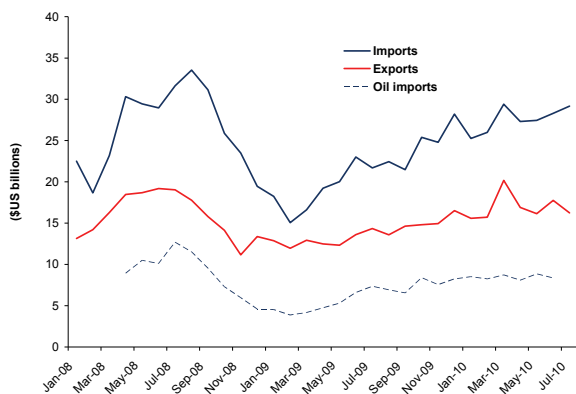


Source: Reserve Bank of India

3. Falling imports

India's imports also fell sharply in 2008/9, partly due to weaker commodity prices. This fall was steeper than the drop in exports, thereby improving the balance of payments position and supporting economic growth.

Figure 3: Imports and exports (monthly, \$billion)



Source: IMF and Indian Ministry of Finance

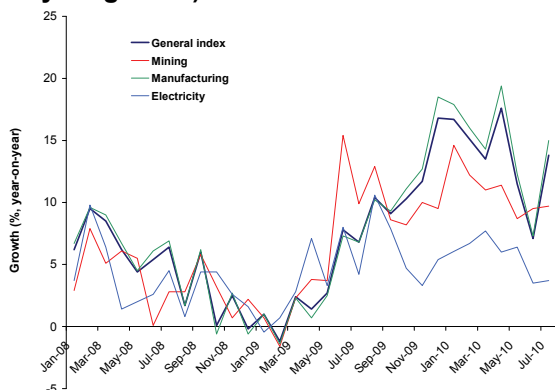
4. Strong domestic demand

Another source of stability has been the strength of India's domestic services sector, which accounts for nearly 60% of GDP. Similarly, agricultural production, which accounts for 15% of India's GDP, has also remained robust during the worldwide downturn.

Having come through the crisis, what now?

After weathering the crisis very well, the outlook for the next 1-2 years looks bright. Industry is growing very fast (Figure 1) although the sector has benefited from flattering year-on-year comparisons with low growth a year ago (implying that reported growth rates may drop back by early 2011). Figure 4 shows the monthly pattern up to July 2010 (the latest month for which information is available). Industrial production is still growing by 14% and manufacturing at 15% - though this is somewhat less than the peak growth achieved at the turn of the year.

Figure 4: Index of industrial production (year on year growth)

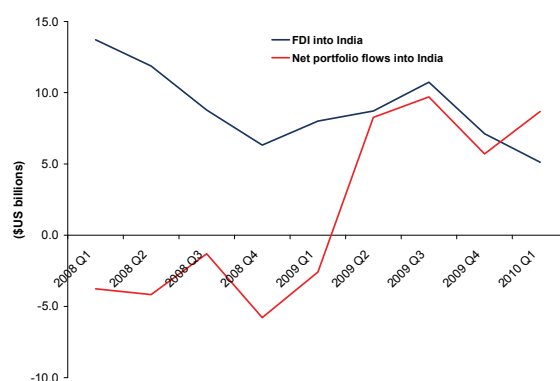


Source: Indian Ministry of Finance

Agriculture should see better growth this season as the monsoon rains arrived on schedule and have delivered average rainfall. Concerns remain that climate change has made the rains more erratic than they used to be but, if the rains are normal, agricultural output will benefit from year-on-year comparison with a poor monsoon last year.

On top of that, consumer and business confidence have returned. Credit growth has picked up and equity prices remain high. One of the most visible signs of this renewed confidence is the recovery in capital inflows – Figure 5. The World Bank estimates that the inflow of portfolio and foreign direct investment was \$60 billion in FY 2009/10 compared to only \$7 billion in FY 2008/9.

Figure 5: Capital flows into India (\$billion)



Source: Indian Ministry of Finance

Headwinds remain

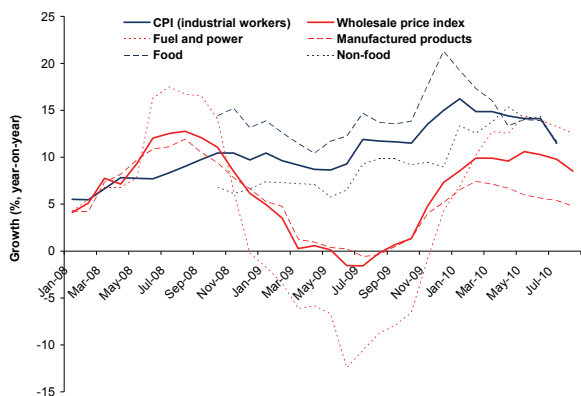
So far, so good. But there are headwinds which suggest that Indian growth will struggle to regain the 9+% peak it achieved briefly before the crisis. China has recorded 9-10% growth rates over many years but India finds it hard to emulate this record.

The first concern is that high inflation is prompting a response from the central bank in the form of monetary tightening. In July, consumer inflation for industrial workers was 11.5%, slightly below the recent peak but still worrying for the government (see Figure 6). Rising food prices, which make up nearly half of the inflation index, have been one of the main causes of the surge in inflation. Food inflation reached 22% last December though the rate eased to around 12% by July. The latest wholesale price inflation (for August) also shows that core inflation (excluding food and fuel) remains high, suggesting that strong consumer and business demand has given producers pricing power.

Nevertheless, the government hopes that a normal monsoon will make a big difference to headline inflation as increased agricultural output

feeds through into lower prices. Higher food stocks than last year also help. But the central bank has already started a modest tightening in the last six months, raising interest rates and the banks' cash reserve ratio. It is still early days and the government will still hope that, with food prices easing, it has done enough to bring inflation down to a more acceptable level.

Figure 6: Inflation (year on year change)



Source: Labour Bureau, Indian Ministry of Finance

Another constraint on growth could be the need to rein in the budget deficit. The reduction in central and state budget deficits before the crisis gave the government space to introduce a stimulus package in late 2008 to offset the slowdown in the economy. As a result the combined deficit has returned to around 10% of GDP and the debt to GDP ratio has risen to 77%. Although these figures are no worse than European and US levels, they are high by emerging country standards and are not sustainable in the medium term.

The Government of India has set itself the target of cutting the debt to GDP ratio to 68% by FY2014/2015. Some of the improvement will come from revenue reforms which are in the pipeline and high GDP growth will also help, unlike in Europe and the US. The IMF has also drawn attention to the need to phase out subsidies that mainly benefit the well-off, though this will face political resistance. Failure to rein in the fiscal stimulus as the private sector recovers could maintain pressure on inflation and crowd out private investment.

Although India is a relatively closed economy it does rely on capital inflows to ease the negative impact of a current account deficit. Sovereign debt problems in Europe and the general determination to cut back budget deficits have recently raised concerns that the global recovery could suffer a setback. If this were to happen, financial flows to emerging markets, including India, could well dry up.

Infrastructure bottlenecks are the other frequently mentioned constraint. This is certainly not a new

story. India has coped with poor infrastructure (electricity, roads, ports, water, sanitation) for a long time and it did not prevent an acceleration in growth after the start of the reforms in 1991. Nevertheless poor infrastructure does impose a cost on the economy. The government has responded in the last budget, promising a 24% increase in infrastructure spending. Although this will help to ease the situation, it takes time to get new projects started and meanwhile growth will continue to suffer, particularly in those sectors like manufacturing and exporting which are most dependent on good infrastructure. The services sector is less affected though shortages in electricity and the frustrations of congested transport do hold growth back in this sector too.

Where does this leave the outlook for growth over the next two years?

It seems clear that India is experiencing a significant recovery, at least compared with the sluggish state of the economy early last year. This has been based on improving consumer spending and investment, with imports acting as a bit of a brake.

In part, it is because of favourable year-on-year comparisons that India's economic recovery looks so good, but the recovery is nevertheless impressive and is based on a competent response by the Indian government to the crisis. Assuming normal monsoon rains and crops, the outlook for this year, therefore, is good. Somewhat slower growth should be expected for 2011 and 2012. Table 2, showing recent IMF and World Bank forecasts, suggests that this will be the case though the World Bank sees the peak next year rather than in 2010.

Table 2: GDP growth forecasts

	2009	2010	2011	2012
IMF	5.7	8.8	8.4	8
World Bank	5.7	8.3	8.6	8.2

Sources: World Bank's Global Economic Prospects, June 2010 and IMF's Regional Economic Outlook, April 2010

In view of the current risks and uncertainties, it might be sensible to look for slightly slower growth in the 7-8% range after the surge this year to 8-8.5%. Only if there is another leg to the crisis and a collapse in confidence would we expect a return to around 5%, a rate which has not been seen in India for a decade.

Some wider issues

The need to re-start economic reforms

Now that the immediate dangers from the economic crisis have been addressed and the economy is recovering fast, attention can turn to some wider and longer-term issues which will affect India's prospects. The first is the need to re-start the economic reform process which has been on hold for some time now.

Since 1991, India has been moving from a command economy to one increasingly based on the market. Although this has led to an acceleration in growth, many constraints and problems remain. One is the unsatisfactory state of business regulation. Government Ministries and their public-sector undertakings (PSUs) have been reluctant to give up their monopolies and the power to regulate in their sectors. Regulation has been ad hoc and incomplete, with the result that there is uncertainty, overlapping regulation and political interference.

Telecoms is now open and actively regulated but other sectors such as energy are way behind, with the government continuing to set prices, while roads, railways and gas are still virtually PSU monopolies. This lack of clarity discourages investment. At least some of the infrastructure bottlenecks could be eased if the regulatory framework were clearer and the private sector were able to invest more easily in these areas.

The Government recognises the need to make progress here and Montek Singh Ahluwalia of the Indian Planning Commission has recently introduced a bill in parliament to lay down some ground rules and to set up a 'commission of commissions' to try to ensure independence from political interference but also accountability to parliament. The sectors to be covered would be electricity, oil, gas, telecoms, broadcasting, postal services, roads, ports, airports, railways and water. This bill is out to consultation but it is likely to face resistance from vested interests within central and state governments and possibly also from the minority parties in the United Progressive Alliance coalition.

A second reform issue which needs attention is the regulation of financial markets. This is currently a confused area, with both the Insurance Regulatory Authority and the Stock Exchange Board of India frequently disagreeing about the regulation of capital markets.

A third area which would benefit from reform is the deepening of capital markets. The IMF has frequently advised India to develop its corporate bond market. Currently, commercial banks in India are limited in what they can do because of

the short-term nature of their deposits when compared with the long-term and risky needs of infrastructure projects. The IMF directors, commenting on the last (Article 1V) assessment of the Indian economy in February, stressed "the importance of developing a vibrant corporate bond market and reforms that would foster greater participation by pension funds and the insurance sector in funding infrastructure".

The government has, however, just moved to deepen capital markets by raising the minimum public shareholding of companies listed on Indian stock exchanges from 10% to 25% within five years. While the implications of this directive, for example, for the government's ability to raise funds to meet its budget deficit, have yet to be understood, it should lead to a surge in the raising of new capital by listed companies. This is likely to happen whether they need it or not.

Other political and social problems should not be forgotten. These include rising inequality, separatist movements in some states and the difficulties flowing from burgeoning and largely unplanned urbanisation. In this review, we have focused primarily on economic reforms though it should be recognised that conditions for businesses are mainly determined at the local (state) level, so social and political developments in the regions will have a significant impact on business.

Exchange rate policy

Economic recovery has been accompanied by a rise in the rupee. The driver has been the strong inflow of capital mentioned earlier, which has more than covered the relatively small current account deficit: a positive balance of payments is thus forcing the rupee to appreciate. This has left the central bank with a dilemma – accommodate the rise in the rupee to bear down on inflation or resist it to prevent Indian companies becoming uncompetitive.

The Reserve Bank of India typically conducts a 'managed float' policy, intervening in the foreign exchange market to smooth changes. But now it faces pressure from exporters and the Confederation of Indian Industries to curb the appreciation by reducing capital inflows in a more radical way, essentially through capital controls. While this would reduce pressure on the rupee it would make capital scarcer and thus more expensive.

The basic problem stems from the rapid growth in the economy and the longer-term solution is to ease the pressure by reducing public sector deficits and creating space for the private sector. This will not happen quickly and in the meanwhile the central bank will have to juggle controlling

inflation with the need to keep Indian exports competitive. Experience so far suggests that the central bank has favoured action to combat inflation. However, if the harvest turns out to be good and food price inflation falls, it will be under less pressure to raise interest rates.

Trade policy

India has moved a long way from its inward-looking and protectionist stance. The number of duties and their levels have been reduced, electronic systems introduced, trade and customs classifications harmonized. According to the Ministry of Commerce and Industry, exports rose from \$63bn in 2003/4 to \$168bn in 2008/9, taking India's share of world exports to 1.45%: this is better than it seems as India was stuck at 1% or less previously.

Services have led this surge. Between 2003 and 2008 India's service exports doubled their share of world trade in services, from 1.4% to 2.8%. The speed of this opening up has been very impressive, and only surpassed by China. But, because it started from such a low base, India's trade is still dwarfed by China's.

The government's trade policy to 2014 is set out in the Ministry's 'Foreign Trade Policy 2009 – 2014'. Its objective is to double India's exports of goods and services by 2014 and it hopes the private sector will achieve this with the help of

fiscal incentives, institutional changes, and rationalization of trade procedures and diversification of export markets. This will require improved infrastructure, lower transaction costs and refunds of indirect taxes. Imports of capital goods will actually be encouraged in order to upgrade India's technology and exports.

The implementation of a freer trade policy still has a long way to go. India's tariff structure has a complicated system of customs duty exemptions for export promotion purposes. Applied tariffs are still on the high side though well below the bound levels that could theoretically be applied. They are often changed on an ad hoc basis, with a damaging effect on competitiveness. It also offers scope for protectionism and special pleading. One area where this has been an issue is agriculture. In the now-defunct Doha Round, India was very protective of its low-income farmers. While this is no different from many countries around the world, it does make it more difficult for the government to avoid inflation spikes following poor monsoon rains as food plays such a large part in the inflation index. This domestic constraint alone argues for greater reflection in India on the benefits of further opening up to world trade.

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