India

The economic slowdown bottomed out last year. A spell of global financial turbulence caused capital outflows and pressure on the exchange rate, but strong policy measures stabilized the currency, rebuilt reserves, and narrowed the excessive current account deficit. Weaknesses remain, however, and include persistent inflation, fiscal imbalances, bottlenecks to investment, and inefficiencies that require structural reforms. Without a systemic resolution to these, growth is forecast to pick up modestly.

Economic performance

The government's initial estimates peg GDP growth at 4.9% in FY2013 (ended 31 March 2014), slightly higher than the ADO Update 2013 forecast of 4.7%. The estimate could be a tad optimistic, as achieving it would require growth to be boosted to 5.5% in the fourth quarter of FY2013 (Figure 3.17.1). The marginal pickup in headline GDP growth masks underlying weakness in the economy as it was due to stronger agriculture. Excluding agriculture, GDP growth slipped from 5.0% in FY2012 to 4.9% in FY2013.

The recovery of the monsoon in the season's second half in 2012 and a good monsoon in 2013 helped agriculture to grow by 4.6% in FY2013, though growth moderated somewhat in the second half of the year. Food grain production is estimated to have increased by 2.4% in FY2013, reaching a record of 263.2 million tons.

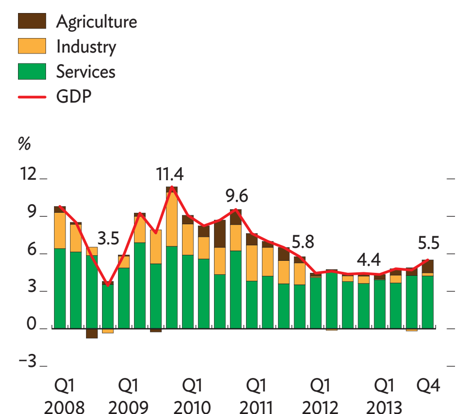
After growing by a tepid 1.0% in FY2012, industry decelerated further to 0.7% in FY2013. While mining has been in the red for nearly 2 years because policy bottlenecks plaguing coal and natural gas have seen little resolution, the contraction in manufacturing output was a new low. Continuing contraction in the output of capital goods and consumer durables reflects very weak investment and consumer demand (Figure 3.17.2). Bottlenecks restricting fuel supplies have hampered electricity generation.

The industrial slowdown and weak recovery in advanced economies caused growth in services to drop below 7%. Trade, hotels, transport, and communication services, which together account for more than a quarter of GDP, saw growth slump to 3.5% in FY2013 as industry weakened and consumption dried up. Growth in the large financial services industry is estimated at a healthy 11.2%. However, much of this expansion is attributed to strong deposit mobilization as large inflows came from Indian nonresidents under a temporary foreign exchange swap window. This appears to be largely a one-off event.

Growth in private consumption slowed sharply to 4.1% in FY2013. A weak currency, persistent food inflation, rising fuel prices, and dim

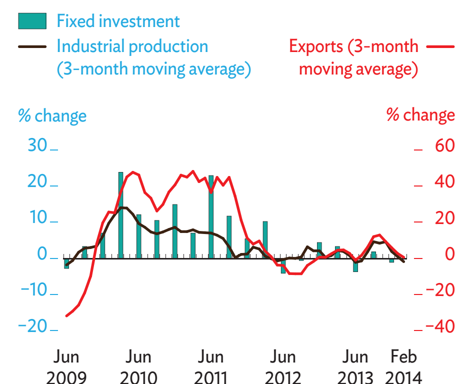
This chapter was written by Abhijit Sen Gupta and Nidhi Kapoor of the India Resident Mission, Asian Development Bank, New Delhi.

3.17.1 Supply-side contributions to growth



Note: Years are fiscal years. Q1 refers to data for April–June.
Source: CEIC Data Company (accessed 14 March 2014).

3.17.2 Investment, industrial production, and exports



Source: CEIC Data Company (accessed 14 March 2014).

employment prospects severely dented consumer confidence. Rural consumption is likely to have been affected by some moderation in rural wage growth since January 2013. Growth in government consumption, which sharply picked up in the first quarter, remained subdued for the rest of the year as fiscal pressures intensified. Investment flattened during the year, registering no growth. While structural and procedural delays continued to hamper investment, new headwinds appeared in the form of monetary tightening and the heightened challenge of repayment in foreign currency as the currency weakened. Domestic demand contributed less than half of growth.

Consumer price inflation averaged 9.8% in FY2013, while wholesale price inflation averaged 5.9%. Inflation picked up for both from May with higher food prices and periodic increments in fuel prices (Figure 3.17.3). However, from December 2013, inflation decelerated sharply due to a drop in food prices, especially for vegetables. Marked currency depreciation during the year affected import prices, though the pass-through to final prices has been limited by weak demand, which has curtailed firms' pricing power and forced them to tighten margins.

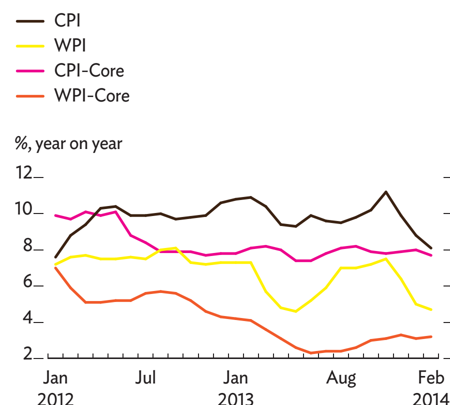
The Reserve Bank of India, the central bank, had to calibrate monetary policy to balance weak growth with concerns over external and price pressures. After reducing the policy repurchase rate by 25 basis points to 7.25% in the first quarter of FY2013 to foster growth, it had to force market rates much higher in July, using its marginal standing facility rate, which it increased to 10.25% (Figure 3.17.4). This was to counter intense pressures on the exchange rate and reserves from turmoil in global capital markets stemming from fears that the US Federal Reserve was about to abruptly end quantitative easing. This action and others in September to buttress capital flows effectively dealt with external pressures. Subsequently, the central bank underlined its firm commitment to bring down inflation (while mindful of slack in the economy) by pushing up the repurchase rate to 8.0%.

A committee that the central bank set up in December 2013 proposed using the consumer price index as the nominal anchor for monetary policy and the adoption of an inflation target of 4%±2%, to be achieved over 2 years. While the advantage of having a clear nominal anchor to influence expectations is widely acknowledged, a debate continues on inflation targeting, as it would depend critically on better coordinated monetary and fiscal policy, more accurate forecasting, and an improved transmission mechanism.

The quality of commercial bank assets continues to be a major concern. The ratio of nonperforming loans to all loans worsened to 4.2% in September 2013 from 3.4% in March 2013. Over the same period, the ratio of restructured loans to all loans also increased, to 6.0% from 5.8%, taking the ratio of stressed loans to over 10% (Figure 3.17.5). The publicly owned banks that dominate the banking system hold a disproportionate share of stressed loans.

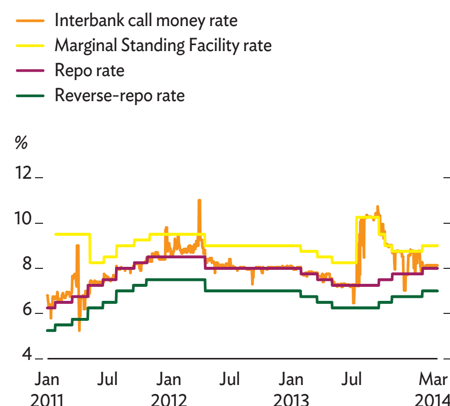
The federal budget deficit in FY2013 is estimated at 4.6% of GDP, slightly less than the 4.8% recorded in FY2012. However, the quality of fiscal consolidation is a concern. Revenue growth was, at 15.9%, well below the target. Collections of corporate tax and customs and excise duties were weakened by tepid economic activity, and receipts from

3.17.3 Inflation



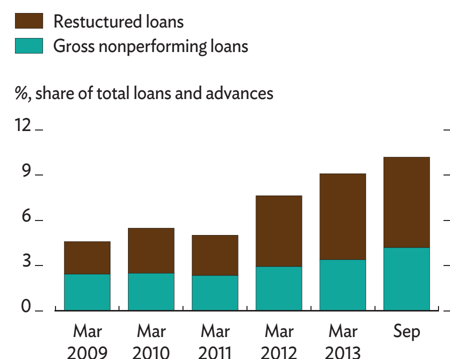
CPI = Consumer price index, WPI = Wholesale price index.
Sources: CEIC Data Company (accessed 14 March 2014); ADB estimates.

3.17.4 Policy interest rates



Source: Bloomberg (accessed 14 March 2014).

3.17.5 Nonperforming and restructured loans



Source: Reserve Bank of India. http://www.rbi.org.in

asset sales were less than half of the target despite the government benefitting from a strong response to the auction of the telecom spectrum. To meet the deficit target, expenditure was compressed, with the burden falling disproportionately on growth-enhancing capital expenditure, which came in at 15% below target, while current expenditure was maintained as planned. Subsidy payments, though capped at 2% of GDP, were 10.6% higher than targeted, as a weak currency pushed the cost of fertilizer and petroleum higher than originally budgeted. In a bid to narrow the fiscal deficit, petroleum subsidies equal to about 0.3% of GDP have been deferred to FY2014.

The current account deficit is estimated to have narrowed sharply to 2.2% of GDP in FY2013 from 4.7% a year earlier. The improvement reflected a large compression of the trade deficit from 10.4% of GDP in FY2012 to 7.9%, mainly owing to a 7.0% drop in imports. Imports of oil, the largest item, were stagnant, while those of gold, the second largest, fell by 45.2% from a year earlier as higher taxes and quantitative restrictions took hold. However, the decline in imports was broad based, with the economic slowdown hitting imports of capital goods such as machinery and transport equipment. Competitiveness gains from a weaker currency and the pickup in demand in some of the advanced economies helped exports to grow by 4.7% in FY2013 (Figure 3.17.6). Exports of petroleum products, fabrics, garments, and plastics grew at a robust pace. Improved services receipts and a modest advance in transfers narrowed the current account deficit by an amount equal to 0.1% of GDP.

A favorable swap scheme for domestic banks initiated by the central bank as one of the September 2013 stabilization measures garnered $46 billion before its expiration in November, mainly from 3-year deposits from nonresident Indians. This facility was a major contributor to rebuilding international reserves after they dipped to $275 billion in early September, helping to restore them to $297 billion in mid-March, a couple weeks before the end of the FY2013 (Figure 3.17.7). While there were substantial net outflows of portfolio investment from June through August during the global market turmoil, subsequently there have been sizeable net inflows, especially to purchase local currency bonds (Figure 3.17.8). With the strengthening and stabilizing of the rupee and marked narrowing of the current account deficit in the second half of the year, global investors moved back into bonds, which allowed them to lock in profit in a covered transaction. However, net foreign direct investment, estimated at $20 billion, improved little on the FY2012 figure.

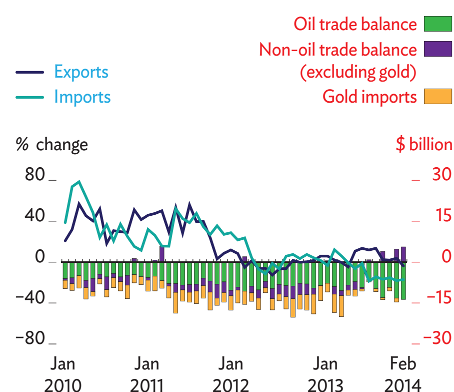
Policies that have improved reserves and substantially strengthened the external position are reflected in exchange rate developments. The Indian rupee depreciated by about 20% against the US dollar from May to its low at the end of August but has subsequently appreciated to trade in March 2014 at about 10% below its rate a year earlier (Figure 3.17.9). The average real effective rate has depreciated about 6%, aiding competiveness. Stock prices declined by 7% from March to August 2013 but recovered sharply for a gain of around 19% in FY2013 (Figure 3.17.10). Despite difficulties, markets in India were more positive over the year than emerging markets averages either in Asia or globally.

3.21.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.5	6.0
Inflation	6.0	5.8
Current account balance (share of GDP)	–2.5	–2.8

Source: ADB estimates.

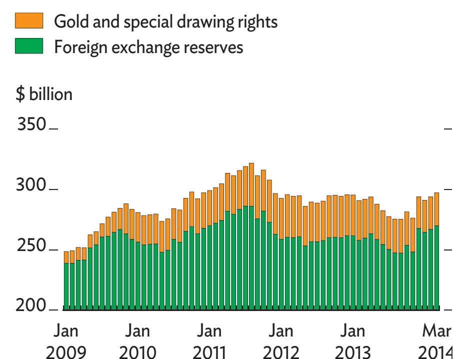
3.17.6 Trade indicators



Note: Separate data for gold imports available up to January 2014 only. Non-oil trade balance for February 2014 includes gold.

Source: CEIC Data Company (accessed 25 March 2014).

3.17.7 International reserves



Source: CEIC Data Company (accessed 25 March 2014).

Economic prospects

Economic recovery would have to be led by improved investment and consumption, but the prospects do not appear promising at this stage. Elevated inflation, a tight monetary stance, and a weak currency will continue to constrain spending. Further, fiscal austerity is likely to be an additional drag on growth.

While the quarter ending in December 2013 witnessed a healthy increase in the number of new projects announced, most were government projects (Figure 3.17.11). At the same time, the number of stalled projects continued to increase with the withdrawal of coal block allocations placed earlier with private sector operators and problems related to acquiring land.

The Cabinet Committee on Investment has cleared projects with a combined worth of $89 billion or 4.8% of GDP. This is likely to provide some traction toward resolving issues with some of the stalled projects. The government is likely to initiate actions that would bolster capital expenditure, as companies are looking for macroeconomic stability and forward movement on some structural issues before commencing operations. Better growth prospects in the US and the euro area will likely bolster external demand, as will competitiveness gains from currency depreciation.

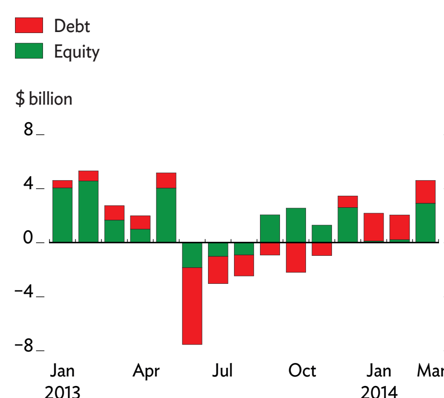
A favorable monsoon is assumed to help agriculture grow at close to its trend rate of 3%. However, some global weather agencies have reported the increased chance of a weak El Niño in 2014, which could reduce rainfall in India and suppress agriculture growth.

Industry is likely to achieve a marginal uptick in growth with mining clearances and improved electricity generation. The HSBC India Manufacturing Purchasing Managers' Index rose in February 2014 to its highest level in a year (Figure 3.17.12). The increase was driven by improvement in current indicators such as output and in forward indicators such as new orders and export orders. Improved global prospects are likely to boost tradeable services such as finance, communication, and information technology and business services, but the HSBC Services Sector Activity Index for February remained below par despite some improvement. The central bank's Business Expectation Index continued to strengthen in the fourth quarter of FY2013 on improved sentiment regarding production, order books, capacity utilization, and exports (Figure 3.17.13).

The economic downdraft of recent years appears to have calmed, and GDP growth in FY2014 is expected to inch upward by 5.5% on improved performance in industry and services. In FY2015, economic growth is expected to pick up to 6.0%, as a speeding up in advanced economies bolsters external demand and government action opens some structural bottlenecks that have impeded industry and investment.

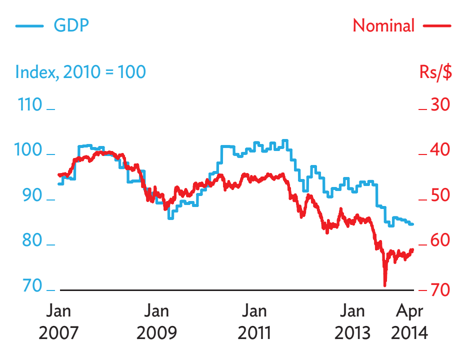
Consumer price inflation is expected to ease below the double digit rates witnessed in recent years but will continue to be high. Record production of food grains in FY2013 will help to soften food prices. Government policies on support prices for procuring food grains under the National Food Security Act will bear heavily on food inflation. A monsoon disrupted by El Niño could fuel food inflation. Improvements in agricultural productivity and the marketing and distribution of

3.17.8 Capital flows



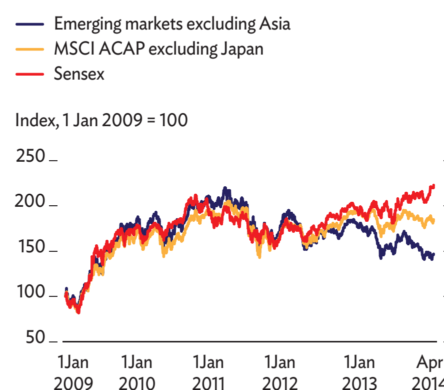
Source: Securities and Exchange Board of India. http://www.sebi.gov.in

3.17.9 Exchange rate



Source: Bloomberg (accessed 25 March 2014).

3.17.10 Stock price indexes



Source: Bloomberg (accessed 25 March 2014).

perishables are needed. Monthly diesel price hikes will need to continue for more than a year if the government is to eliminate this subsidy. On balance, consumer inflation will likely average 8.1% in FY2014 and moderate further to 7.8%, assuming no adverse shocks to agriculture. Wholesale price inflation, which has a smaller food component and excludes services, is expected to average 6.0% in FY2014 and 5.8% in FY2015. These projections assume that monetary policy will remain tight, as consumer price inflation, which has persistently trended higher than wholesale price inflation, is increasingly viewed as the nominal anchor, making the inflation target of 4% ±2% within the next 2 years a bigger reach.

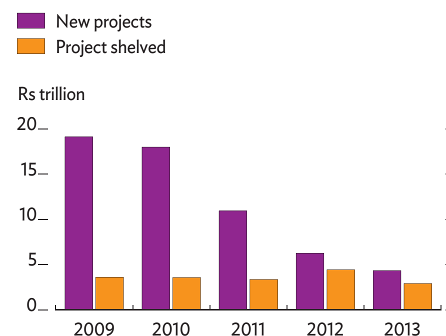
This being an election year, an interim budget was presented in February 2014. The fiscal deficit is seen dropping to 4.1% of GDP in FY2014, which appears optimistic. With no major increase in tax rates, tax revenue collection is expected to increase by 19% in FY2014 on account of higher projected tax buoyancy. Meanwhile, excise duty for capital and consumer goods has been reduced from 12% to 10% to stimulate growth. Personal income tax and excise and customs duties are projected to grow at rates higher than the average over the past decade, indicating assumptions of a manufacturing rebound, expanded tax coverage, and a dynamic global environment in FY2014. At 0.4% of GDP, projected revenue earnings from asset sales are also on the ambitious side, up from an average of less than 0.3% over the past 5 years.

While current expenditure is estimated to grow by 10.8%, capital expenditure growth is pegged at 11.7%. With nominal GDP growth at 13.4%, this implies a further reduction in the ratio of capital expenditure to GDP. Subsidies have been maintained in FY2014 at FY2013 levels in absolute terms, as lower fuel subsidies offset a higher food subsidy with the introduction of the National Food Security Act, 2013. Fuel subsidies are likely to overshoot their budgets in FY2014 as arrears of around 0.3% of GDP from FY2013 were rolled into FY2014. Further, the cap on the number of cooking gas cylinders eligible for subsidies was recently raised, and the losses incurred by oil marketing companies rose because of the weaker rupee.

Improved global growth momentum in 2014 and the recent weakening of the rupee should spur exports, which are expected to increase by 8.0% in FY2014. Imports are also likely to grow, at 9.0%, as imports of items other than oil and gold respond to a modest upturn in growth. Softer international oil prices are likely to keep oil imports in check. Gold imports will likely witness an uptick as some of restrictions are gradually eased to accommodate the large jewelry and gem-setting industry. Better growth prospects in the advanced economies and high domestic interest rates should bolster remittance inflows. The FY2014 current account deficit is expected to be 2.5% of GDP, slightly higher than FY2013.

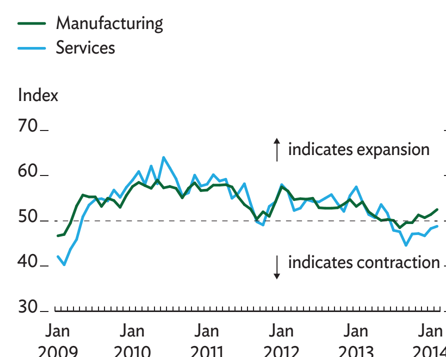
In FY2015, the current account deficit is expected to widen further to 2.8% of GDP as import demand grows by 12% with improvements in investment and industry. Export growth is also expected to pick up to 10.5% as the advanced economies consolidate their growth momentum. While the current account deficit is expected to be comfortable in

3.17.11 New projects and projects shelved



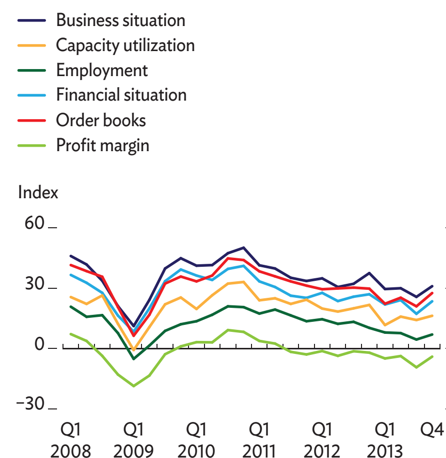
Note: Years are calendar years.
Source: Centre for Monitoring Indian Economy.

3.17.12 HSBC Markit India purchasing managers indexes



Source: Bloomberg (accessed 17 March 2014).

3.17.13 Industrial outlook survey



Note: Years are fiscal years. Q1 refers to data for April–June.
Source: Reserve Bank of India. http://www.rbi.org.in

FY2014 and FY2015, and financed by capital inflows, the economy remains susceptible to external shocks. A large part of the moderation in the current account deficit has been achieved through discretionary curbs on gold, which cannot be sustained over the long run. Similarly, export competitiveness, restored by a sharp depreciation in mid-2013, will slowly erode under high inflation and stagnant productivity. Moreover, the economy continues to import large volumes of essential commodities such as crude oil, coal, and fertilizer because domestic production is constrained. As demand for them is inelastic, a hike in international prices or a marked weakening of the rupee would damage external stability.

Policy challenge—expanding manufacturing to create jobs

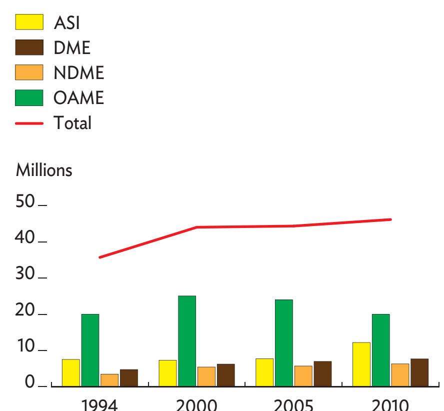
One of India's most pressing policy challenges is to create significantly more productive and well-paying jobs. Such jobs are vital to sustain high growth and ensure that it is inclusive. As the proportion of the workforce that depends on agriculture declines, and given the 12 million people enter the workforce each year, manufacturing will have to play a key role in generating productive and well-paying jobs.

In many ways, manufacturing is well placed to play this role. First, India's factor endowments provide an abundance of semiskilled labor, which is essential for a comparative advantage in labor-intensive manufacturing. Second, India has developed the capabilities required for a diversified and dynamic manufacturing industry in terms of the range of manufactured products produced and of India's manufactured export basket, which includes relatively sophisticated chemical and pharmaceutical products, as well as auto components. Moreover, India's information technology and engineering services have increasingly been deployed by multinational corporations for designing industrial products for global markets, including sophisticated memory chips used in a range of electronic devices.

Unfortunately, manufacturers in India do not perform close to their tremendous potential. For many years now, the sector has contributed around 15% of GDP and 12% of employment. By comparison, manufacturing in the People's Republic of China, Malaysia, Thailand, and Viet Nam accounts for close to 25% or more of GDP.

While employment shares in some of these countries are similar to India's—for example, a little above 15% in Thailand—the large majority of Indian manufacturing employment is concentrated in small, informal enterprises. As Figure 3.17.14 shows, the largest share of manufacturing employment in India is in the informal sector "own account manufacturing enterprises," which employ no wage-workers. Though the most recent data suggest a welcome decline in this segment of manufacturing employment from 2005 to 2010, Indian manufacturers by and large continue to be small and informal, which translates into low productivity and wages. Figure 3.17.15 shows low average wages generated by the informal sector and low average wages paid by small firms in the formal sector relative to their larger counterparts.

3.17.14 Manufacturing employment



Notes: Years are fiscal years, ending on 31 March of the next calendar year.

ASI – Annual Survey of Industries: represents formal enterprises—those registered under the Factories Act, and employing at least 10 workers if using power or 20 workers if not using power.

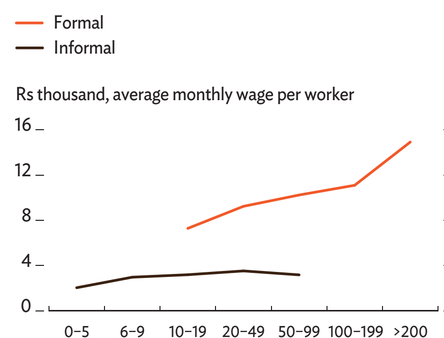
DME – Directory Manufacturing Etablishement: represents informal establishments with 6 or more workers (household and hired workers taken together).

NDME – Non-directory Manufacturing Establishments: represents informal establishments with less than 6 workers (household and hired workers taken together).

OAME – Own Account Manufacturing Enterprises: represents informal enterprises that are run without any hired workers employed on a regular basis.

Source: Annual Survey of Industries and National Sample Survey Organization.

3.17.15 Wage gap between formal and informal manufacturing in India



Source: Annual Survey of Industries and National Sample Survey Organization.

Infrastructure deficiencies, especially for power and transport, and a difficult regulatory environment for manufacturing loom large in discussions and analyses of the factors holding back manufacturing. Rigorous empirical work has begun documenting how insufficient and irregular power supply affects firms' product choices, output, and scale of operations. Also, for products such as apparel that have geographically dispersed domestic supply chains, poor connectivity and logistics raise transaction costs and damage global competitiveness. Similarly, the World Bank's 2014 *Doing Business* study on regulations ranks India 134th of 189 countries for ease of doing business. Particularly problematic are regulations on starting a business, obtaining permits, and closing unprofitable units. Further, elements of India's labor laws, especially those pertaining to layoffs in manufacturing plants, seem to have discouraged larger and more productive firms from entering labor-intensive product lines.

Recognizing the importance of a more dynamic manufacturing industry, the government unveiled in 2011 its new National Manufacturing Policy, which calls for boosting the share of manufacturing to 25% of GDP and adding 100 million workers by 2022.

To achieve these targets, the policy proposes rationalizing and simplifying business regulations, including the use of single-window clearance mechanisms; an exit policy that aims to balance firms' need to adjust employment in response to market conditions with labor's need for income security; financial and institutional mechanisms to develop technology, especially for small and medium-sized enterprises; large-scale infrastructure development; and clustering manufacturers in new national investment and manufacturing zones.

These zones will be developed as industrial townships, benchmarked with the best manufacturing hubs in the world. They will also help meet growing demand in India for world-class urban centers. Further, they will address infrastructure bottlenecks. These zones will be equipped with necessary infrastructure, particularly power, either through grid connection or by power plants in the zone. They will also seek to minimize supply chain fragmentation and its associated costs.

The government is transforming major transport corridors into economic corridors and promoting greater industrial activity along them. In addition, the Cabinet Committee on Investment has been set up to speed clearance for stalled infrastructure projects throughout the country.

The successful implementation of these recent initiatives will be necessary to ensure that India's manufacturers perform at or close to potential.