India

Growth slowed slightly in fiscal 2018 as expansion in agriculture and services slipped, even though industry and investment strengthened. The current account deficit widened but remained modest, while inflation continued to be benign. The outlook is for growth to edge up on strengthened domestic demand and bank and corporate fundamentals. Inflation and the current account deficit should remain tame. Export performance can be enhanced by improving conditions for participation in global value chains.

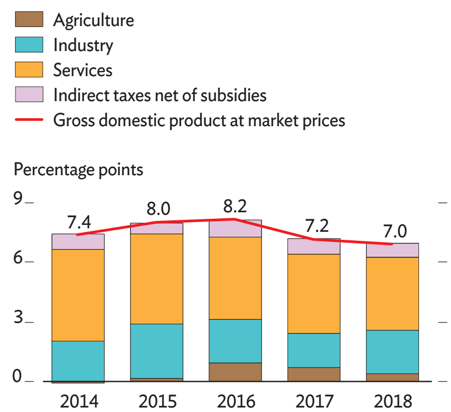
Economic performance

Economic growth slowed to 7.0% in fiscal year 2018 (FY2018, ended 31 March 2019) according to preliminary official estimates, slightly down from 7.2% in FY2017 (Figure 3.17.1). Growth slowed progressively during the year, partly from a base effect. The slowdown reflected subdued agriculture, which grew by only 2.7%, the lowest in 3 years. Food grain production was robust but slightly below the harvest in the previous year, mainly with a shortfall in cereals and pulses. Production from livestock rearing, fisheries, and forestry is estimated to have grown at a healthy rate.

Growth in industry sharply increased to 7.7% in FY2018, owing to strong manufacturing, construction, and utilities. Manufacturing expanded by 8.1%, helped by strong expansion in corporate earnings. The index of industrial production grew solidly, reflecting robust demand for capital equipment, construction goods, and consumer durables. Construction clocked robust growth at 8.9%, aided by government spending on affordable housing and new infrastructure, especially roads. However, mining grew by a meager 1.2% as contraction in crude oil and natural gas production offset strong growth in the output of coal.

Services slowed to 7.4%, their lowest growth rate in 7 years. Growth in trade, hotels, transportation, and communication remained sluggish with only subdued growth in the freight and passengers carried by railways, and in cargo handled by ships. Small and medium-sized enterprises, which account for a large part of this sector, may have struggled to comply with new regulations under the goods and services tax (GST), undermining the sector's performance. An uptick in credit and deposit growth helped financial, real estate,

3.17.1 Supply-side contributions to growth



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

Sources: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in; CEIC Data Company (accessed 1 March 2019).

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

and professional services grow at marginally higher rates than in the previous year, though stress on shadow banks likely dented growth somewhat. Government steps to reduce GST rates for some real estate activities are thought to have provided a boost to this industry. Finally, a government slowdown in current spending slowed growth in government services including public administration, defense, and the "other services" category.

On the demand side, private consumption was the main driver of growth in FY2018 (Figure 3.17.2). It grew by 8.3%, the highest rate in 7 years, despite rural consumption remaining sluggish under subdued crop prices, slow growth in rural wages, and stress on nonbank lenders. Consumption is likely to have received impetus from reduced GST rates across a wide range of commodities during the year and a cut in key monetary policy rates. Government consumption slowed, as expected, because of tightened finances.

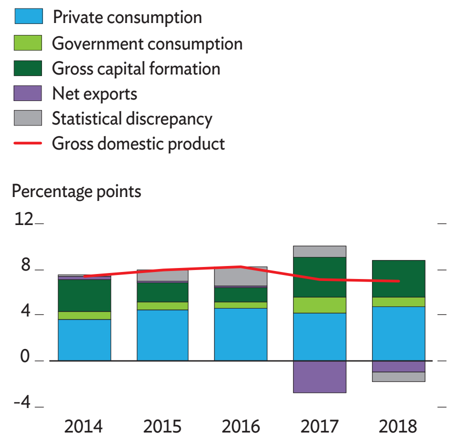
Gross fixed capital formation grew by a robust 10% in FY2018 despite coming off a high base. It was sustained by growth in central government capital expenditure by a robust 20.3% as investment in roads, railways, and urban infrastructure remained strong. Private investment is estimated to have increased a bit, reflecting a pickup in lending to industry, an uptick in capacity utilization, and increased production of capital goods.

Headline retail inflation averaged 3.5%, the lowest since a new metric was introduced in 2011. It declined steadily, especially from the second quarter of FY2018 (Figure 3.17.3). The headline number masks, however, a lot of heterogeneity. Much of the decline can be explained by muted food prices, which occupy 46% of the consumer price basket, as their average annual increase in FY2018 was only 0.7%. Prices for vegetables, sugar, and pulses fell significantly during the year as robust production created a supply glut, and as prices for cereals, fruit, milk products, and edible oil increased only modestly. Slow growth in rural wages squelched purchasing power in rural areas, reducing demand for food and pushing food inflation down further.

By contrast, core inflation remained elevated at 5.6% on price increases for housing, education and recreation services, and health care. Fuel inflation also remained strong on account of both higher global oil prices and Indian rupee depreciation.

Muted headline inflation prompted the Reserve Bank of India, the central bank, to reduce key policy rates by 75 basis points in FY2018, taking the repo rate to 6.25% (Figure 3.17.4). The most recent cut, in February 2019, was prompted by a drop in household inflation, a reduction in the output gap, and the general assumption that fiscal deficit targets would be met. The central bank also indicated a change in monetary policy away from calibrated tightening, under which policy rates

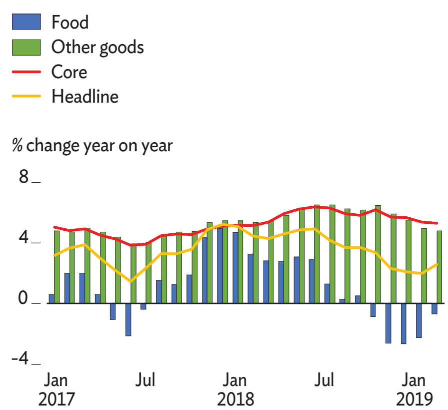
3.17.2 Demand-side contributions to growth



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

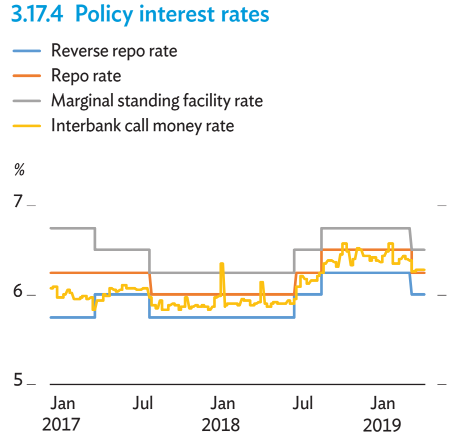
Sources: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in; CEIC Data Company (accessed 1 March 2019).

3.17.3 Inflation



Sources: CEIC data company (accessed 13 March 2019); ADB estimates.

3.17.4 Policy interest rates



Sources: Bloomberg; CEIC Data Company (accessed 8 March 2019).

could be only raised or kept unchanged, to a neutral stance, allowing rates to be changed in either direction.

Growth in bank credit rose from 7.0% in FY2017 to 11.9% in FY2018 largely on higher credit to services and personal loans (Figure 3.17.5). Within the service sector, credit to nonbank financial companies enjoyed the biggest increase, aiming to restore liquidity to this troubled business segment. Professional services and wholesale trade also benefited. Credit to industry inched up a bit over FY2017. Credit to infrastructure has picked up over the past few months, albeit from a low base.

Initial results are heartening, after various steps were taken to improve the health of the bank sector, including a review of stressed assets in 2015, the introduction of new guidelines for resolving insolvency and bankruptcy in 2016, and the recapitalization of selected banks. The share of nonperforming loans in all loans declined from 11.5% in March 2018 to 10.8% in September 2018 (Figure 3.17.6). This first decline in nonperforming loans since 2016 was broad-based, with public, private, and foreign banks all experiencing declines.

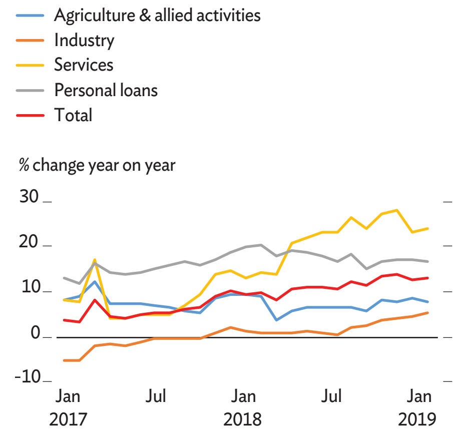
The nonbank financial sector, which has played a vital role in meeting credit needs, has been under stress since a default by a large player. This likely tightened financial conditions, raising the cost of capital.

The government fell marginally short of its fiscal deficit target for FY2018, the deficit finally equaling 3.4% of GDP, above the 3.3% target (Figure 3.17.7). One reason was the introduction of an agricultural income support program under which small farmers received ₹6,000 per year. The scheme will be implemented retroactively from December 2018 and is expected to cost the equivalent of 0.1% of GDP in FY2018.

Direct tax revenue remained buoyant in FY2018 as improved compliance boosted the collection of personal income tax and healthy earnings bolstered corporate tax collections. GST collection fell short of its target, mainly because tax rates on various commodities were reduced during the year. Revenue growth from customs and excise taxes was flat for goods that remain outside of the GST. Central government revenue received a fillip from strong growth in dividends from the central bank and receipts from charges for telecommunication spectrum use. The government's disinvestment targets are estimated to have been met for a second year in a row.

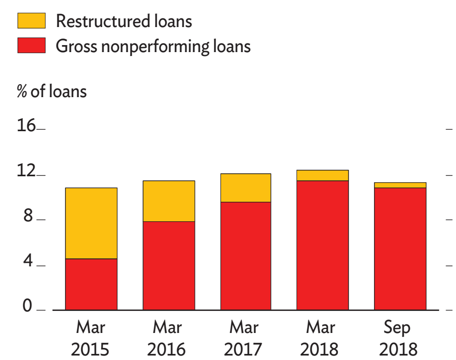
Central government capital expenditure grew by a robust 20.3% in FY2018 on increased outlays for roads, railways, and defense. In addition, capital spending by public sector enterprises grew by 5.5%. Growth in current expenditure was more modest at 13.9%. Apart from income support to small farmers, other contributors to mounting current expenditure were higher food subsidies, interest payments, and outlay on pensions.

3.17.5 Bank credit



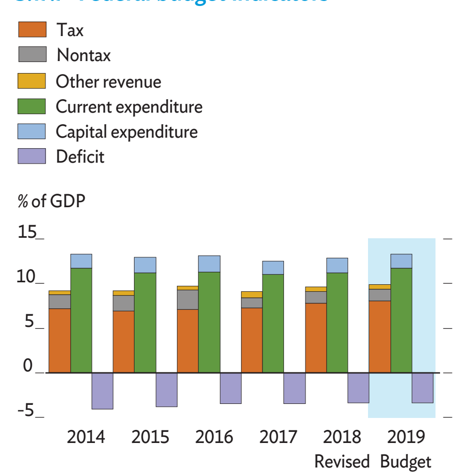
Source: Bloomberg (accessed 8 March 2019).

3.17.6 Stressed loan ratio



Source: Reserve Bank of India (accessed 8 March 2019).

3.17.7 Federal budget indicators



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

Source: Ministry of Finance Union Budget 2016–2018. http://indiabudget.nic.in.

After rebounding in FY2017, import growth slowed to 9.8% in FY2018, reflecting sluggishness in imports other than oil (Figure 3.17.8). Growth in imports of capital goods declined in the second half of FY2018 in line with weakening economic activity. Gold imports contracted from the previous year, possibly indicating subdued rural demand. In contrast, higher oil prices and domestic consumption propelled oil import growth by more than 32.0%.

Exports grew by 8.9%, slightly slower than in the previous year. Export growth was buoyed by strong growth for refined petroleum exports, aided by the rise in global prices. Non-oil exports grew by a meager 6.0% despite a low base. Healthy growth in exports of electronics, chemicals, pharmaceuticals, machinery, and textiles was countered by contraction in exports of metals and leather products.

The surplus in services grew by only 3.0% in FY2018 even though software exports revived after 3 years of stagnation. Exports of transportation, travel, and business services also increased, though financial service exports dipped. Remittances grew robustly as higher oil prices boosted growth prospects in oil-producing countries, where many Indian migrants work. On balance, the FY2018 current account deficit is estimated to equal 2.3% of GDP.

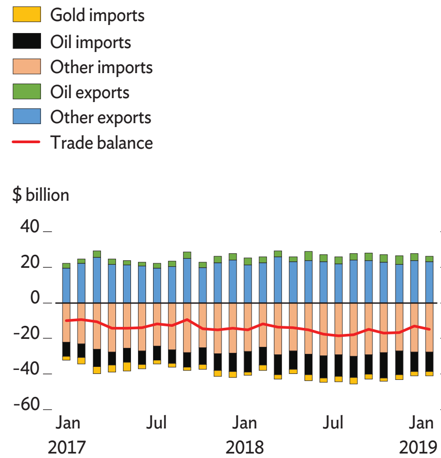
Net foreign direct investment inflows were, at $32 billion in FY2018, slightly higher than in the previous year. By contrast, net portfolio investment flows turned negative with strong outflows from India in the first half of FY2018 as investor sentiment dampened in response to rate hikes in the US, rising oil prices, a worsening current account deficit, and uncertainty over India meeting its fiscal deficit target (Figure 3.17.9). Despite the withdrawal of foreign portfolio investors, the stock market climbed by over 10% in FY2018, substantially outperforming other emerging markets in Asia and the rest of the world as domestic investors upped their stakes (Figure 3.17.10).

The Indian rupee depreciated by 7.2% against the US dollar during FY2018, reflecting the widening current account deficit and tepid foreign investment flows (Figure 3.17.11). It depreciated by about 3% in real effective terms. India's international reserve holdings declined by $22 billion in FY2018 to $398 billion (Figure 3.17.12).

Economic prospects

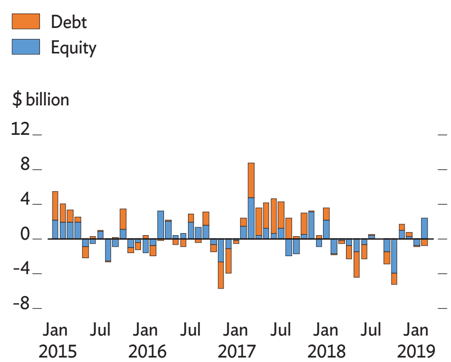
Domestic demand is expected to remain the main driver of growth. Steps to alleviate agriculture distress such as income support to farmers and strong hikes to procurement prices for food grains are expected to bolster rural demand. The implementation of farmer income support will face some start-up challenges because it demands accurately linking

3.17.8 Trade indicators



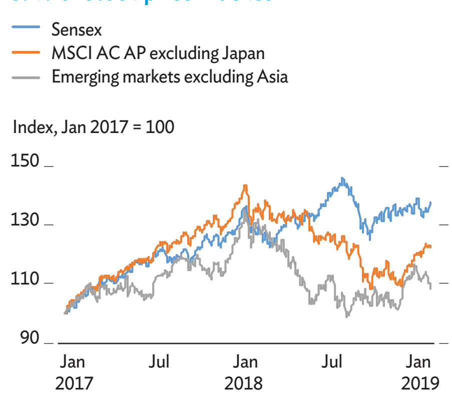
Sources: CEIC Data Company (accessed 6 March 2019); ADB estimates.

3.17.9 Portfolio capital flows



Source: Security and Exchange Board of India.

3.17.10 Stock price indexes



Source: Bloomberg (accessed 8 March 2019).

land records with farmers' bank accounts. In urban areas, consumption demand is expected to receive a boost from interest rate cuts, continued low prices for food, and declining fuel prices. The central bank's index of consumer confidence reached in December 2018 its highest reading in nearly 2 years (Figure 3.17.13).

The recent pickup in investment growth is expected to continue, albeit at a slow pace. The improvement in nonperforming loans held by banks, and the resulting easing of credit restrictions on certain banks, are expected to boost lending to industry. The central bank's industrial outlook survey showed business expectations in the last quarter of 2018 reaching their highest in more than 4 years (Figure 3.17.14). Similarly, the share of respondents expecting capacity utilization to improve in the coming quarters was the highest in 6 years, which is likely to spur private investment. Public sector capital formation is likely to be muted, with capital expenditure by the central government and its public enterprises forecast to decline from an estimated 5.1% of GDP in FY2018 to 4.5% in FY2019. Any investment revival will be dampened a bit by a decline in new project announcements in FY2018, even as the number of stalled projects increased.

Current weather points to a normal monsoon, suggesting healthy growth in agriculture, helped by a low base in FY2018 and steps to improve agricultural productivity.

Surveys provide a mixed outlook for manufacturing. The Nikkei purchasing managers' index indicates steady improvement in recent months for manufacturing, given strong growth in new orders (Figure 3.17.15). In contrast, a downward trend in the Nomura composite leading index indicates some moderation in growth outside of agriculture. Manufacturing is likely to benefit from lower borrowing costs and rising demand for consumer goods, aided by government measures to boost disposable incomes. The purchasing managers' index for services has inched up since from the middle of 2017, though dipping a bit in the most recent months. Moderating growth prospects in the advanced economies hurt tradeable services, though this was mitigated by a more competitive currency.

In sum, growth is forecast to pick up modestly to 7.2% in FY2019 on revived rural consumption, continued growth in private investment in response to improved bank and corporate balance sheets, more competitive domestic firms and products under the GST, and less drag from net exports. Growth in public investment is likely to be modest for lack of funds. Growth is expected to edge up further to 7.3% in FY2020 on dividends reaped from recent reforms to improve the business climate, strengthen banks, and alleviate agricultural distress.

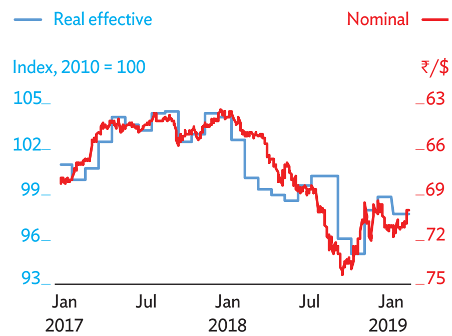
The forecast has some downside risks. Exports could suffer if the following threats exceed expectations: moderation in global demand as financial conditions tighten, uncertainty

3.17.1 Selected economic indicators (%)

	2019	2020
GDP growth	7.2	7.3
Inflation	4.3	4.6
Current account balance (share of GDP)	–2.4	–2.5

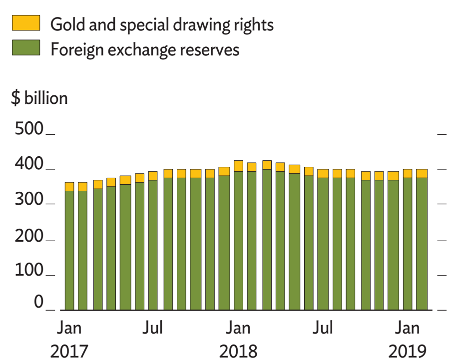
Source: ADB estimates.

3.17.11 Exchange rates



Source: Bloomberg (accessed 8 March 2019).

3.17.12 International reserves



Source: CEIC Data Company (accessed 8 March 2019).

arising global trade tensions, and weakness in the economic outlook in the industrial countries. On the domestic front, growth could suffer if tax revenue falls short or any disruption affects the ongoing resolution of the twin problems of bank and corporate balance sheets.

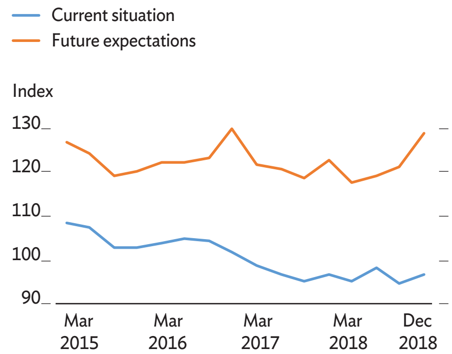
Inflation, remaining largely benign in FY2018, is expected to inch up in FY2019. Food inflation is likely to experience a mild uptick as some of the increase in procurement prices passes on to retail prices. Any increase in input costs such as wages and fertilizers could also push up food prices. Mistimed or misdirected rainfall could damage harvests and stoke food inflation. Average global oil prices are expected to be 13% lower in 2019 than last year. However, retail prices for deregulated fuels like gasoline and diesel are unlikely to decline by this much because the government is likely to raise taxes on them to boost revenue, as it has done in the past. Core inflation is expected to persist at current rates as proposed budget measures to raise disposable income would bolster aggregate demand. The lagged impact of the recent depreciation of the rupee will force up prices for imported goods. In sum, inflation is likely to average 4.3% in FY2019, rising to 4.6% in FY2020 as market prices firm up and domestic demand strengthens.

Inflation below expectations in FY2018 opened some space for monetary policy stimulus. With inflation expected to average below 4.0% in the first half of FY2019, the central bank could further lower policy rates. However, the extent of any easing would be restrained by fiscal concerns and the risk of stoking food inflation.

The central government put fiscal consolidation on hold in FY2019 by targeting a deficit equal to 3.4% of GDP, close to the FY2018 outcome, and higher than the earlier target of 3.1% of GDP. Part of the divergence was on account of the agricultural income support scheme and tax relief to people earning up to ₹500,000. Central government tax revenue is forecast to grow by 14.9%, an ambitious follow-on from high 19.5% growth in FY2018. Improved compliance and measures to broaden the tax base will help personal income tax to grow, but the 17.2% growth target may be a bit ambitious given tax concessions in the budget. Similarly, the growth target of 18.2% in GST revenue seems a bit optimistic. Nontax revenue is forecast to grow by 11.2%, aided by strong growth in dividends from the central bank and other financial institutions. Divestiture and strategic sales are expected to raise ₹900 billion, equal to 0.4% of GDP, which is ambitious but achievable.

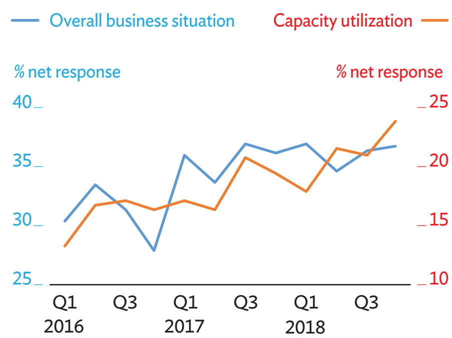
Current expenditure growth, forecast at 14.3%, is more than growth in capital expenditure, which is budgeted at 6.2%. Further, as in the previous years, a significant part of capital expenditure will be undertaken by public enterprises, though as a percentage of GDP it is lower than in the previous year. Higher current expenditure is predicated on increased outlays

3.17.13 Consumer confidence



Source: Reserve Bank of India (accessed 8 March 2019).

3.17.14 Industry outlook survey of manufacturing



Q = quarter.
Source: CEIC Data Company (accessed 20 March 2019).

of committed expenditure. Subsidies are budgeted 11.7% higher, primarily to raise the cooking gas subsidy. Interest payments are also budgeted higher by 13.2%.

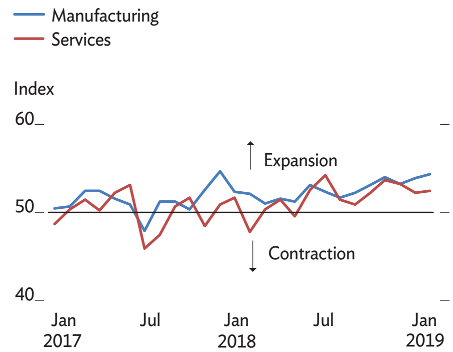
Exports of refined petroleum products are expected to grow at a slower rate as oil prices dip and growth slows in the industrial economies and the People's Republic of China (PRC). Part of this will be offset by improved exports other than oil or gold, which will benefit from a more competitive currency. Overall merchandise exports in FY2019 are expected to grow by 8.0%, slightly slower than in FY2018. Import growth is also expected to slow with lower oil prices and weakening currency. A revival in rural income could bolster gold imports. Similarly, an uptick in investment could draw in more imports of capital goods. On balance, import growth is expected to slow to 8.0% in FY2019.

The surplus in services could narrow a bit with weaker growth in the industrial economies. Growth in remittances is similarly expected to moderate for this reason—and with slower growth in oil-exporting countries—as both groups employ large numbers of workers from India. On balance, the current account deficit is expected to equal 2.4% of GDP in FY2019.

Recent gains in the ease of doing business and a healthy growth outlook are likely to attract strong inflows of foreign direct investment. Portfolio debt flows may weaken a bit with policy rates lowered in FY2019, reducing the interest rate differential with industrial economies. Portfolio equity flows are expected to remain robust. Overall capital flows are expected to finance the current account deficit, though a shortfall may require a modest drawdown of reserves.

In FY2020, export growth is expected to remain modest at 7.0% as growth in the industrial economies slows further. Stable oil prices will help moderate import growth, though non-oil imports are likely to grow at a slightly faster pace as growth inches up. Overall import growth is projected to be 8.0%. The current account deficit is forecast to widen slightly to the equivalent of 2.5% of GDP in FY2020.

3.17.15 Purchasing managers' indexes



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

Source: Bloomberg (accessed 6 March 2019).

Policy challenge—enhancing participation in global value chains

India's merchandise exports have grown from $35.7 billion in 2000 to $298 billion in 2017, at an average annual rate of 12.2%, nearly double growth in global exports. This has raised India's share of global exports from 0.7% in 2000 to 1.7% in 2017. Despite improvement, India's share in global exports trails that of other large Asian economies like the PRC at 12.7%, Japan at 3.9%, and the Republic of Korea at 3.2%. It is similar to the shares of smaller economies like Thailand at 1.3%, Malaysia at 1.2%, and Viet Nam at 1.2%. Recently, policy makers have delineated numerous strategies to improve India's export performance in strategy documents like *Foreign Trade Policy 2015–20, Strategy for New India @75, and Unlocking the Potential of Micro Small and Medium Enterprise Exports.*

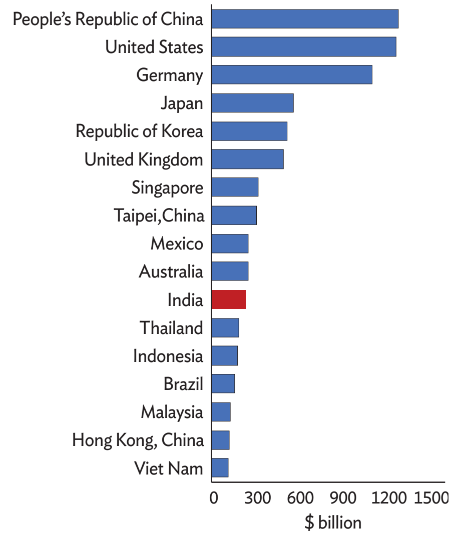
India could improve its export performance by enhancing its participation in global value chains (GVC), as GVC exports account for more than 70% of global exports over the past 8 years. India's GVC exports in 2017 came to only $241 billion (62.7% of overall exports), significantly below $1,314 billion for the PRC, $577 billion for Japan, $533 billion for the Republic of Korea, $329 billion for Singapore, and $318 billion for Taipei,China (Figure 3.17.16). Sectors that dominate India's GVC exports include coke and petroleum, chemicals, basic and fabricated metals, textiles, and electrical and optical equipment.

Economies that have the highest increase in GVC participation, measured as the ratio of GVC exports to all exports, also experience the sharpest rise in all exports measured as a percentage of GDP (Figure 3.17.17). Enhanced GVC participation is similarly associated with other development goals for India: a higher share for manufacturing in GDP, faster job creation, and faster economic growth.

GVC participation benefits from low trade barriers. As GVCs depend on goods crossing international borders multiple times, high trade costs from high tariffs or nontariff barriers are passed on to the downstream firms, raising the cost of the finished goods. This affects the production and investment decisions of firms involved in GVCs. According to the Global Competitiveness Index compiled by the World Economic Forum, India's tariffs remain significantly higher than average in emerging markets. Lowering them would improve GVC participation. International trade costs depend as well on the time and cost involved in complying with customs and border procedures. Although India has made substantial progress in this regard, as evidenced by a sharp improvement in recent years in its World Bank rank for trading across borders, its rank at 80 out of 190 in 2018 shows that there is still scope for improvement. Improvement in trade across borders was one of the factors that helped India jump 23 places to 77th position in overall ease of doing business.

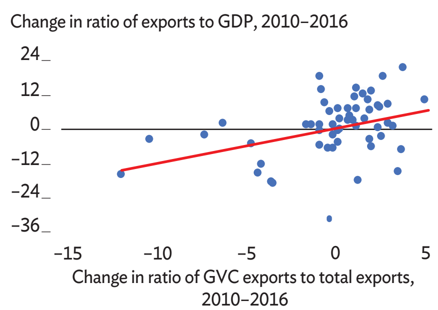
A country's ability to connect with GVCs depends crucially on the quality of its infrastructure. One of the main reasons for geographic fragmentation of production under GVCs is to take advantage of varying production costs across countries and produce each component at its cheapest location. Firms' production costs depend crucially on the quality of infrastructure. Poor electricity supply and frequent outages force a firm to restart the assembly line to restore production, clean up and repair damage to facilities, and dispose of faulty

3.17.16 Cross-country comparison of global value chain exports



Source: ADB Multi-regional Input-Output database.

3.17.17 GVC participation and export performance



GDP = gross domestic product, GVC = global value chain.

Sources: ADB Multi-regional Input-Output database; World Bank. World Development Indicators.

products, all of which substantially raise costs and undermine competitiveness. Similarly, underdeveloped road and rail transport infrastructure impedes connectivity between ports and production centers, slowing production and making it more expensive. While India has substantially improved the quality of its roads, according to the Global Competitiveness Index, the quality of its electricity supply trails that of other emerging markets. Sectors like electrical and optical equipment, transport equipment and chemicals, and rubber and plastics have the potential to be further integrated into GVCs if these impediments are resolved.

Limitations on the finance available for infrastructure argue for concentrating investments in industrial zones. Infrastructure can be developed within such zones with costs shared by the firms present in them, reducing the infrastructure investment required of individual firms. These zones can be strategically located near transport hubs and linked with ports and airports that have better road and rail infrastructure.

Finally, skills development can help countries enhance their productivity gains from participation in GVCs. It allows countries and industries to specialize in higher and medium technology production and in complex business services like chemicals, electrical and optical equipment, and finance and insurance with potential to foster innovation and productivity growth. India faces a formidable challenge in this area, as only an estimated 4.7% of its workforce has received formal training, much lower than in other large economies of Asia: Japan at 80%, the PRC at 24%, and the Republic of Korea at 96%. To close this gap, policies on skills development need to be designed to meet the requirements of both low- and high-technology manufacturing and complex services. It would be prudent to design policies that improve skills across different segments of industries and not focus on too narrow a selection, to avoid misallocation.