

Indian Macro-economic Outlook

*Presentation for
Embassy of Finland*

Taj Palace, New Delhi
14.1.2013

*Alok Sheel**

Secretary, Economic Advisory Council to the Prime Minister of India

** The views in this presentation do not necessarily reflect those of the Indian government*

Overview

- Broad Sweep from Independence in 1947 to the Present
- Recent Economic Growth in Comparative Perspective
- Structural and Cyclical Macroeconomic Issues: SWOT Analysis of the Indian Economy
- Recent and Current Macro-economic Trends:
 - Growth
 - Internal Balance
 - External Balance
 - Inflation
- Looking Ahead: Key Reform Measures and Concerns

GDP Per Capita (\$ PPP) 2010

- India 3550
- China 7640
- UK 36410
- Japan 34640
- USA 47360
- Finland (2009) 33556

India at Independence in 1947

- **Agriculturally backward:** Markets integrated, but food grain deficit and traditional technology.
- **Trade balance in India's favour,** but composition altered over the colonial period from being an exporter of handicrafts to being an importer of finished goods and exporter of primary produce.
- After having been de-industrialized in the early colonial period, modern, especially **textile**, industry took root in the later colonial stage.
- Beginnings of a **modern infrastructure**, physical and social.
- Low or negative growth rates, growing poverty and backwardness compounded by the first stage of the modern **demographic cycle** after 1921, resulting in (continuing) high population growth rates.
- Regional and linguistic **diversity** led to a federal political structure with strong central powers.
- British **parliamentary democracy took firm root.**
- **Economically more advanced than most countries in Asia.**

1950-1980 State-led Growth: Policy

- Thrust on **State-owned heavy** industries based on the Soviet Five Year Plans.
- Private industry permitted but under a stringent **licence permit scheme** so as to limit size and direct investment.
- Physical and social **infrastructure state owned**.
- **Agricultural** development left to private enterprise but with strong dose of state regulation and subsidies that strengthened small-farmers.
- Stringent **capital controls**. Financial sector state-owned to direct investment. Little reliance on external finance.
- **High tax** rates and Low Tax-GDP ratios : Victim of the Laffer Curve?
- Trade policy import-substituting, **inward-looking** and protectionist. Implicit anti-export bias.

1950-1980 State-led Growth: Impact

- Development of a basic **industrial base**, but inefficient because of limited competition and under investment in infrastructure.
- **Green Revolution**: India becomes agriculturally self-sufficient.
- Financial repression and **capital flight**: Mounting NPAs
- Share in world **trade shrinks** from 3% in 1947 to 0.5% in 1990.
- **Low 'Hindu (3.5%)' rate of growth** (compared to NICs of E. Asia)
- A 'licence-quota-permit ('**DUPS**'- **directly unproductive profit seeking**) Raj' spawns a flourishing parallel economy.
- Increase in agricultural productivity from second half of the seventies, and higher growth rates from second half of the eighties, results in **slow reduction in poverty**.
- Massive state expenditures financed by high tax rates and borrowings. **Fiscal and BOP crises** (vulnerable to oil price shocks): proximate cause of economic liberalization of the nineties.

'Changing Tack' in Nineties

- Accumulation of unsustainable internal and external **deficits feeding off each other**, especially following the **global Oil Price hikes** of the seventies.
- Dissatisfaction with economic performance relative to **East Asia**.
- **End of History**: An idea whose time had come?
- A minority government more willing to take **risk**.
- Trigger provided by **BOP** crisis induced by the **Gulf War**.
- First round of reforms **crisis driven** (hence swift); second generation **consensus driven** (hence slow): strong consensus on weak reforms?

Major Economic Policy Changes in the 1990s

- **Industrial:** delicensing and opening up the economy to private, including foreign, investment.
- **Trade:** Sharp reduction and rationalization in custom tariffs and excise, including removal of all quantitative restrictions on trade.
- **Foreign Exchange:** Full float of the rupee on current account, and greater liberalization of the capital account, especially on the non-debt component. External debt capped.
- **Public Sector:** a major thrust on tax-reform, privatization and fiscal deficit reduction.
- **Financial Sector:** Opening up of the Insurance Sector to private and foreign investment, de-regulation of capital market and interest rate, with movement from control to prudential regulation and investor safeguards, and moving away from monetization of the government deficit.
- **Major weaknesses:**
 - Land and labour markets not touched (necessary for private investment in infrastructure, agriculture and labour intensive manufacturing)
 - Lags in public investment in Agriculture and Infrastructure

Impact of Reforms

➤ External Sector stabilized:

- EDT/GDP ↓, FE Reserves ↑ through capital flows easing financing of CAD, real exchange rate stability.
- Economy more open: Trade/GDP ↑ from 17% to 25.1%.
- Rupee Float takes wind out of hawala market.
- Fiscal slippages not allowed to spill over externally.

➤ Domestic, Services led Growth

- ↑ From 3.5% to 6.6% (1992-97:reforms impact), 5.4% (1997-2003:EAC impact), 8.7% (2003-08:global boom impact), 7.5% (2008-12:post global crisis)

➤ Sharp and sustained growth in Savings and Investment

- Savings/GDP ↑ from 19.8% (av. 1980-81 to 1990-91) to 23.7% in 2000-01 to 36.8% in 2007-08
- Domestic capital formation ↑ from 21.8% (av. 1980-81 to 1990-91) to 24.2% in 2000-01 to 38% in 2007-08

➤ Fiscal Management still weak:

- No significant change in consolidated GFD of Centre and States at around 8% of GDP.
- However debt/GDP ratio falling because of spurt in growth

Impact of Reforms: Poverty Decline

(Radhicka Kapoor: *Inequality Matters*, EPW, Vol. 48 No. 2, January 12, 2013)

HCR	Tendulkar Line			\$1.25 a Day (2005 PPP)			\$2 a Day (2005 PPP)		
	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban	Total
1993-94	50.1	31.8	45.3	52.4	40.7	49.4	84.5	71.3	81.1
2004-05	41.8	25.7	37.2	43.8	36.16	41.6	78.7	65.0	74.8
2009-10	33.8(35.2*)	20.9(21.5*)	29.8	34.2	28.93		72.5	56.7	

*Estimates arrived at by Himanshu (2012) after excluding expenditure on MDMS.

Source: Planning Commission poverty data and World Bank POVCAL Net Database.

Recent Economic Growth in Comparative Perspective

Period/Year	World	Adv Econs	EMDEs	India	China	China-India
1994-2003	3.4	2.8	4.4	6.0	9.5	3.5
2004	4.9	3.1	7.5	7.6	10.1	2.5
2005	4.6	2.6	7.3	9.0	11.3	2.3
2006	5.3	3	8.2	9.5	12.7	3.2
2007	5.4	2.8	8.7	10.0	14.2	4.2
2008	2.8	0.1	6.1	6.9	9.6	2.7
2009	-0.6	-3.5	2.7	5.9	9.2	3.3
2010	5.1	3	7.4	10.1	10.4	0.4
2011	3.8	1.6	6.2	6.8	9.2	2.4
2012	3.3	1.3	5.3	4.9	7.8	3.0
2013	3.6	1.5	5.6	6.0	8.2	2.3
Av. 2004-07	5.1	2.9	7.9	9.0	12.1	3.0
Av. 2008-12	2.9	0.5	5.5	6.9	9.3	2.4

The Big Picture Since the Onset of the Global Financial Crisis

- The global economy is growing far below the pre-crisis boom level, but only slightly below the average of 1994-2003.
- Advanced economies are growing at just over 20% of the 1994-2003 and pre-crisis boom level.
- EMDEs growing at 70% of pre-crisis boom average, but 125% of 1994-2003 average.
- China and India at the upper end of the EMDE trend.
- Growth differential between China and India narrowing.

SWOT Analysis of the Indian Economy

- Need to distinguish between *Structural* factors and *Cyclical* issues.
- Structural Factors:
 - Strengths
 - Weaknesses
- Cyclical Issues
 - Opportunities
 - Threats

Structural Factors : Strengths

- **Strong Entrepreneurial class** with global outlook – rapidly taking over ‘commanding heights’ of the economy from the historically dominant public sector.
- **Demographic dividend**: falling dependency ratios associated with higher growth.
- **Rising savings-investment rates** (current decline cyclical?) underlying recent increases in trend growth: importing rather than exporting capital (contrast with China and Russia – high savings but CAS; and Brazil and South Africa – low savings) : adequate capital flows to cover the CAD.
- **Big market with strong domestic demand**: 1b+ population with Gini index lowest amongst BRICS – domestic demand driven economy (contrast with China): advantage in a global downturn.
- **Good financial intermediation relative to EMDE peers**: unaffected by GFC
- **Services, esp. IT** : sunrise sector not overly dependent on heavy infrastructure
- **Floating Xchange rate** and self-limiting external imbalances? : Adequate reserves to cushion against external shocks
- **Market economy with a stable democracy**: No extra-legal expropriations or rollback of decisions once taken – based of broad civil society consensus across the political spectrum and strong judicial oversight.

Structural Factors : Weaknesses

- The **Twin Deficits**:
 - ***High fiscal deficits*** (internal imbalance) – need to rein in subsidies and change fiscal mix; crowding in/out effects
 - ***Large CADs*** (external imbalance): Commodity and POL dependence: high prices, impairing competitiveness?
- Despite similar factor advantages, labour laws and overall investment climate too inflexible relative to China for **labour intensive manufacturing**.
- **Backlog and policy environment in infrastructure investment** (physical and social) a drag on productivity; policy environment (land use policy; user charges; long-term finance) more critical in India because of greater reliance on private & PPP investment.
- **Agriculture**: Low productivity: Share in national income shrinking much faster than share in total labour force. Untouched by opening up and liberalization of the Indian economy since the early 1990s: Market rigidities constraining supply response to prices.
- Poor **Education and Labour skills** can negate the demographic dividend.
- Weak **project implementation and governance**
- **Democracy tax**: Paid upfront: Lack of political consensus on rapid growth as the primary focus. Strong consensus on weak reforms because of multiple objectives? Relative to other EMDEs India needs more growth than inclusiveness?

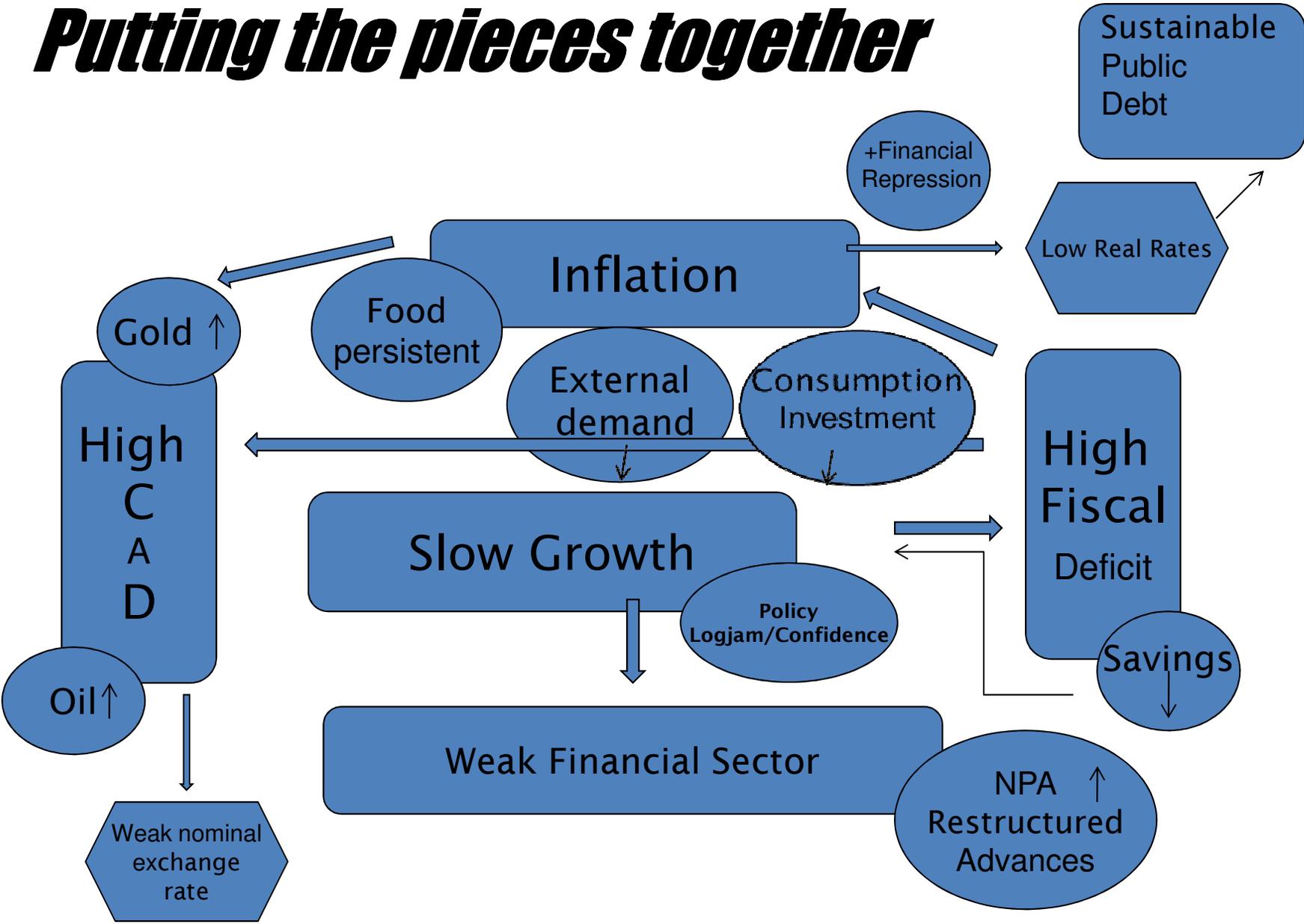
Cyclical Issues : Opportunities

- **High growth creates fiscal space** for infrastructural investment (debt/GDP ratio stable despite large fiscal deficits)
- **QE in AEs supportive of capital inflows**, making financing of CAD easier (FE reserves not drawn down despite large CAD), giving more time to adjust
- **Chinese rebalancing** should make Indian manufacturing more competitive provided structural reforms are undertaken
- **FDI in retail should improve agricultural productivity** through improved infrastructure and capital investment.
- **Cabinet Committee on Investment** to speed up project implementation
- **Structural reforms can boost productivity and unlock inherent structural strengths**, especially in industry (labour costs) and agriculture (labour cost plus natural fertility and photo period advantage)
- **Federal-States equation** and competitive policy environments: major reforms ahead – land and labour markets; agriculture; governance – lie in their domain.

Cyclical Issues : Threats

- **Weak and protracted recovery in advanced economies** – severe downside risks (fiscal cliff: US; financial meltdown: Euro Zone) abating?
- **Persistent inflationary pressures:**
 - Constraining space for monetary policy
 - Negative real interest rates leading to ↓ in financial savings and ↑ in gold
- **Fiscal consolidation being derailed** by the electoral cycle.
- **Rising banking sector NPAs** deriving from declining growth and profitability
- **Basel III** and potential increase in cost of capital
- **Elevated commodity, especially oil, prices** (QE works both ways for India – adverse for oil prices, benign for capital flows)
- Impact of elevated CAD on **External Debt and confidence**
- **Decline in growth out of proportion to decline in investment:** lower productivity?
 - MNREGA: social safety net – rising wages with no productivity shift
 - Fiscal mix tilted towards consumption rather than investment
 - Market rigidities in agriculture feeding into inflation

Putting the pieces together



Economic Growth

At constant 2004/05 prices								
Year-on-year rates of growth in per cent								
ANNUAL RATES		2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
					<i>P</i>	<i>QE</i>	<i>Rev</i>	<i>Pro.j.</i>
1	Agriculture & allied activities	5.1	4.2	5.8	0.1	1.0	7.0	2.8
2	Mining & Quarrying	1.3	7.5	3.7	2.1	6.3	5.0	-0.9
3	Manufacturing	10.1	14.3	10.3	4.3	9.7	7.6	2.5
4	Electricity, Gas & Water Supply	7.1	9.3	8.3	4.6	6.3	3.0	7.9
5	Construction	12.8	10.3	10.8	5.3	7.0	8.0	5.3
6	Trade, Hotels, Transport, Storage & Communication	12.0	11.6	10.9	7.5	10.3	11.1	9.9
7	Finance, insurance, real estate & business services	12.6	14.0	12.0	12.0	9.4	10.4	9.6
8	Community & personal services	7.1	2.8	6.9	12.5	12.0	4.5	5.8
9	Gross Domestic Product (factor cost)	9.5	9.6	9.3	6.7	8.4	8.4	6.5
10	Industry (2+3+4+5)	9.7	12.2	9.7	4.4	8.4	7.2	3.4
11	Services (6+7+8)	10.9	10.1	10.3	10.0	10.5	9.3	8.9
12	Non-agriculture (9-1)	10.5	10.8	10.1	8.1	9.8	8.6	7.1

Fiscal Position in India

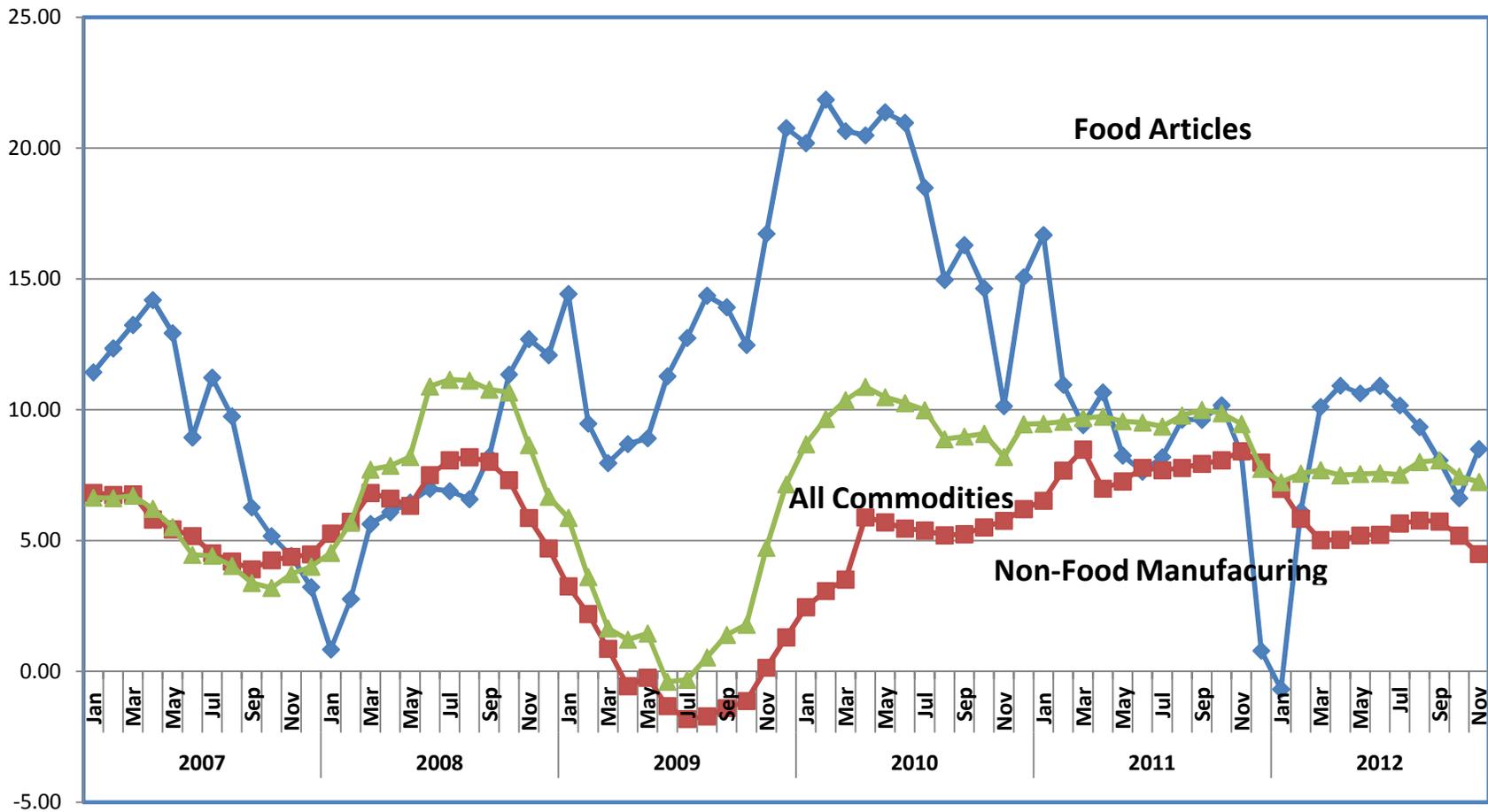
Unit: per cent of GDP

Year	Centre			States			Consolidated		
	Rev. Deficit	Fiscal * Deficit	Primary Deficit	Rev. Deficit	Fiscal Deficit	Primary Deficit	Rev. Deficit	Fiscal * Deficit	Primary Deficit
2002-03	4.40	6.04	1.11	2.33	3.88	1.25	6.64	9.71	3.02
2003-04	3.57	4.62	-0.03	2.19	4.27	1.46	5.79	8.65	1.95
2004-05	2.42	3.90	-0.04	1.21	3.11	0.66	3.54	7.26	1.12
2005-06	2.50	4.73	0.37	0.19	2.33	0.16	2.69	7.26	0.79
2006-07	1.87	4.27	-0.18	-0.58	1.82	-0.37	1.29	6.32	-0.33
2007-08	1.05	3.11	-0.88	-0.86	1.49	-0.49	0.19	4.65	-1.02
2008-09	4.54	8.20	2.59	-0.21	2.40	0.57	4.33	10.62	3.45
2009-10	5.18	6.61	3.14	0.37	2.80	1.03	5.54	9.41	3.99
2010-11	3.29	4.87	1.82	-0.03	2.07	0.45	3.26	6.94	2.13
2011-12 RE	4.46	5.89	2.78	-0.06	2.28	0.74	4.40	8.18	3.41
2012-13 BE	3.45	5.06	1.91	-0.40	2.12	0.59	3.05	7.17	2.41

External Balance

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Merchandise Exports	85.2	105.2	128.9	166.2	189	182.4	250.5	309.8
Merchandise Imports	118.9	157.1	190.7	257.6	308.5	300.6	381.1	499.5
Merchandise Trade Balance	-33.7	-51.9	-61.8	-91.5	-119.5	-118.2	-130.6	-189.8
Net Invisibles	-4.7%	-6.2%	-6.5%	-7.4%	-9.8%	-8.5%	-7.5%	-10.2%
	31.2	42	52.2	75.7	91.6	79.7	84.6	111.6
	4.3%	5.0%	5.5%	6.1%	7.5%	5.8%	4.9%	6.0%
o/w Software & BPO	14.7	23.8	27.7	37.2	47.0	41.5	49.6	60.1
Private Remittances	20.5	24.5	29.8	41.7	44.6	53.5	53.1	63.5
Investment Income	-4.1	-4.1	-6.8	-4.4	-6.6	-5.5	-16.4	-16.5
Current Account Balance	-2.5	-9.9	-9.6	-15.7	-27.9	-38.5	-45.9	-78.2
	-0.3%	-1.2%	-1.0%	-1.3%	-2.3%	-2.8%	-2.7%	-4.2%
Foreign Investment	13.0	15.5	14.8	45.0	3.5	51.2	38.0	39.2
o/w FDI (net)	3.7	3.0	7.7	15.4	17.5	18.8	7.7	22.1
Inbound FDI	6.0	8.9	22.7	34.2	35.0	33.1	24.0	33.0
Outbound FDI	2.3	5.9	15.0	18.8	17.5	14.4	16.3	10.9
Portfolio capital	9.3	12.5	7.1	29.6	-14.0	32.4	30.3	17.2
Loans	10.9	7.9	24.5	41.9	4.1	14.3	27.9	19.3
Banking capital	3.9	1.4	1.9	11.8	-3.2	1.5	5.0	16.0
Other capital	0.7	1.2	4.2	9.5	4.5	-13.0	-10.4	-6.9
Capital Account Balance	28.0	25.5	45.2	108.0	8.7	53.4	60.0	67.8
	3.9%	3.1%	4.8%	8.7%	0.7%	3.9%	3.5%	3.7%
Errors & Omissions	0.6	-0.5	1.0	1.2	1.1	-1.6	-2.6	-2.4
Accretion to Reserves	26.2	15.1	36.6	92.2	-18.1	13.3	11.5	-12.8

Components of (WPI) Inflation



Inflation: Current Trends

Major Price Indices in November 2012			
Item	Percentage Variation over		
	Oct 2012	Mar 2012	Nov 2011
1 Wholesale Price Index (2004-05=100)	0.1	4.8	7.2
1.1 Primary Articles	0.3	6.3	9.4
1.2 Fuel and Power	- 0.6	6.2	10.0
1.3 Manufactured Products	0.1	3.8	5.4
2 Consumer Price Index (2010=100)	0.4	8.6	9.9
2.1 Rural	0.2	9.2	10.0
2.2 Urban	0.7	7.7	9.7
3 Consumer Price Index for Industrial Workers (2001=100)	0.5	8.5	9.5

BOP Current Trends (*Per cent of GDP*)

	2010-11	2011-12	11-12/Q1	11-12/Q2	11-12/Q3	11-12/Q4	12-13/Q1	12-13/Q2
Trade Balance	-7.7	-10.3	-9.8	-9.9	-10.7	-10.6	-10.0	-11.7
Net Services	2.9	3.5	3.6	3.1	3.5	3.6	3.3	3.8
Net Income	2.1	2.6	2.4	2.6	2.7	2.5	2.8	2.5
Current Account Balance	-2.7	-4.2	-3.8	-4.2	-4.4	-4.5	-3.9	-5.4
Net Capital and Financial Account	3.7	3.7	5.2	4.4	1.7	3.4	4.0	5.9

Economic Growth: Recent Quarters

Industry	Percentage change over previous year			
	2011-12		2012-13	
	Q1	Q2	Q1	Q2
1. agriculture, forestry and fishing	3.7	3.1	2.9	1.2
2. mining and quarrying	-0.2	-5.4	0.1	1.9
3. manufacturing	7.3	2.9	0.2	0.8
4. electricity, gas and water supply	8.0	9.8	6.3	3.4
5. construction	3.5	6.3	10.9	6.7
6. trade, hotels, transport and communication	13.8	9.5	4.0	5.5
7. financing, ins., real est. and business services	9.4	9.9	10.8	9.4
8. community, social and personal services	3.2	6.1	7.9	7.5
GDP at factor cost	8.0	6.7	5.5	5.3

Recent Key Measures/Reforms to Stabilize/Enhance Growth :I

- **Monetary measures**: 13 increases (375 bps) in policy rates between Mar 2010 to Oct 2011: to rein in inflationary expectations.
- **User charge Hikes**: Fuel prices - Diesel price hiked by `5/litre; Capping subsidised LPG cylinders at 6/household; Railway passenger fares raised for the first time 10 years: to help in fiscal consolidation and inflation control over the long-term.
- **FDI liberalisation**: Up to 51% FDI in multi-brand and single brand retail subject to conditions; Up to 74% FDI in teleports, mobile TV and sky-broadcasting services; Up to 49% FDI in aviation by foreign airlines: to help finance CAD and boost investment, including in agriculture.
FDI enhanced in an ARC to a maximum of 50 per cent and Investment by FDI and FII together up to 74 per cent. FII investment in Security Receipts beyond 10 per cent allowed: to result in quicker resolution of NPAs in the Banking sector
- **Disinvestment** in PSUs Oil India Limited (10%), MMTC (9.33%), NALCO (12.15%) & Hindustan Copper (9.59%): to help in fiscal consolidation, market efficiency and improved corporate governance

Recent Key Measures/Reforms to Stabilize/Enhance Growth :II

- **Reduction in withholding tax and tax on overseas borrowings** by domestic companies during July 2012–June 2015 to 5 % from 20%, (Subject to conditions): to help finance the CAD
- **Financial restructuring of state distribution companies** (Discoms): accumulated losses of discoms estimated at `1.9 trillion as at the end of 2010-11: to help contain financial problems in the power sector, a key infrastructure sector.
- **Cabinet Committee on Investment** headed by the PM to clear infrastructure projects above a certain threshold: to accelerate Infrastructure investment and project implementation.

Key Reforms in the Pipeline

- **Composite GST legislation**. Pending with the Parliamentary Standing Committee on Finance: rationalize tax structure to make it more buoyant and assist in fiscal consolidation.
- **Land Acquisition Bill** : to help address a major bottleneck in project implementation, especially in infrastructure.
- **Further liberalisation, including FDI, in insurance & pension sectors** : to help raise domestic and foreign savings and long term funding for infrastructure; also help in funding the CAD.
- **Key economic legislations** such as amendments to the Companies Act, Forward Contracts Act, Competition Act and Banking Act: to improve Corporate governance, financial intermediation and overall economic efficiency.

Key Concerns

- ***Short-term***
 - Getting growth back on track
 - Anchoring inflationary expectations
 - Containing the fiscal deficit
 - Stabilizing the external sector
- ***Long-term***
 - Policy initiatives for creating productive service and industrial jobs to move people out of low productivity agricultural jobs without destroying overcrowded cities.

Thank You