India's Economic Prospects and Challenges

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Situation

The global recession has affected Indian growth through investment. In January 2009, significantly less investment and a higher interest rate following the recession through 2008 were estimated to have slowed growth in FY 2008/09 (April-March) to 6¼ %. Growth projections in May and June 2009 for FY 2009/2010 were 5.5%. As the U.S. and European economies seem to be recovering, India is expected to grow by 6.3% in FY 2010/2011, but growth is not expected to reach 8-9% again in the next 2-3 years, during which it will probably remain at 6-7%.

But other GDP components remained strong. Although investment freezes affected the economy, its relatively low dependence on exports limited the impact of the global recession. Furthermore consumption, a crucial component of the Indian economy, remained strong in the rural as well as informal sectors. About 2/3rds of all employment is in the rural sector, which accounts for ½ of incomes in the country.

The economy continues to grow, but the recession has lowered the growth rate of GDP, which averaged 8.9% between 2003 and 2007. Growth had been sustained by market-oriented reforms implemented in the mid-1990s[2], followed by stable macroeconomic fundamentals and favorable external environments, making India the second Asian economic powerhouse after China. Growth had been broad-based, including not only the services sector (as in the 1990s) but also manufacturing, construction, agriculture, real estate and transport.

The drying up of credit funding to banks and corporations was the determining factor in the growth rate declines. By mid-2008, as pessimism about the economy in general set in and corporate profits were expected to drop, the shortage of credit threatened to increase the value of nonperforming assets (NPAs) in the banking sector. The banks had been a significant source of credit to the private sector and a major facilitator of growth in the past years.

To make matters worse, banks and corporates had significant amounts of foreign exchange (FX) debt. Out of total corporate debt, between 20% and 30% was FX debt. In January 2009, a large number of foreign bonds and loans to domestic banks and corporates were set to fall due. Although the legally allowed degree of FX exposure of Indian banks had been low, there was no

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[2] After India almost defaulted on its external obligations in 1990-1991, the government implemented wide-ranging reforms aimed at restoring fiscal and trade balances and curbing inflation. It then began structural reforms aimed at removing government controls on the economy as well as liberalizing the FDI and trade regimes.

telling how many corporate borrowers had not hedged their foreign debt. By late 2008, the number of corporations unable to service their debt was thought to have doubled. Potential maturity mismatches in banks' books also presented risks.

The exchange rate depreciated markedly. In 2008, the value of the rupee fell by 23% versus the U.S. Dollar and by 11% in real effective terms. Although roughly in line with its equilibrium level, a weaker rupee made FX debt even more problematic. However, the rupee was not expected to depreciate further in 2009, and in July 2009 it was expected to slightly appreciate against the U.S. Dollar in 2010.

India's foreign exchange reserves fell. Between May 2008 and January 2009, US$60 billion in FX reserves were lost (from US$315 billion to US$255 billion) due to capital outflows and the central bank's (Reserve Bank of India, RBI) intervention in currency markets to support the rupee.

India's external position deteriorated sharply. The current account deficit was projected to rise from 1½% of GDP in FY2007/2008 to 3¾% in FY2008/2009, largely due to a 50% climb in the price of oil imports in mid-2008. It was expected to return to its 2007/2008 level this fiscal year thanks to lower oil prices, lower domestic demand, and rupee depreciation (expected to keep exports constant), then widen again in 2009/2010 because of rising imports.

The deficit in the government budget rose towards the end of 2008. This occurred because of slower economic activity and the implementation of government stimulus measures and other expenses not fully provisioned in the budget. In July 2009, the central government predicted a deficit of 6.8% of GDP. In addition, the aggregate deficit in the states' budgets for FY2008/2009 was expected to reach 2¾%. Additional spending was projected in September and October 2008 during the announcement of two supplementary budgets. The latest budget, released in July 2009, announced large expenditures on the rural sector, infrastructure, and social programs. Important reforms to tighten the central government's budget are therefore very unlikely to occur in the near future.

Rainfall during the 2009 monsoon season (June-September) has been low. The monsoon provides about 80% of India's annual rainfall. As of the beginning of October 2009, data showed that rainfall had been inadequate over most of India. While there was no telling yet how severely this would affect agricultural production, it is likely that scarce rainfall will put additional pressure on government spending due to the economic impact of a bad harvest.

Seventy percent of Indians depend on farm incomes, 60% of all farms depend on monsoon rains for production, and the Indian government provides substantial farm subsidies (food, fuel, and fertilizer). A bad harvest would affect incomes, household wealth, and by extension

consumption, which is an essential part of GDP. A bad harvest would therefore require additional government spending to alleviate those impacts.

The fiscal situation risked endangering India's recent poverty reduction achievements. India has made strides in combating poverty. In 1990, 51% of Indians lived with less than $1.25 purchasing power parity (PPP)/day; in 2005 that number was 41.6%. However, the government's weak fiscal position does not bode well for the sustainability of social programs, a significant source of support for the poor. Spending on social sectors such as health and education are also likely to suffer. Carefully balancing fiscal restraint with the need for social expenditure will be critical, though challenging, given the present situation. Securing the participation of the private sector for health and education through private-public partnerships could alleviate the government's fiscal burden.

Wholesale price inflation has declined substantially since mid-2008 but the CPI continues to rise. Wholesale price inflation had more than halved (down to 6%) by the end of 2008 and was expected to decrease further in FY 2009/2010, to an average of 2%. However, consumer price inflation was expected to average 6% in 2009 and 4.7% in 2010.

Policy developments

The authorities changed their monetary policy stance quickly. In September 2008, the RBI changed its stance from inflation- to growth-targeting and took measures to ease the flow of credit to the banking sector such as cutting interest rates and reserve requirements. These and subsequent measures addressed the liquidity crunch of late 2008. As of August 2009, interest rates had been cut to 4¾ %.

Nonetheless, credit remains expensive. Despite the improvements at the end of 2008, in August 2009 commercial lending rates were still higher than the policy rates. This reflected lenders' apprehension towards sectors that had previously borrowed extensively, such as real estate, small- and medium-sized enterprises (SMEs), nonbank financial corporations, and consumers. Given the decreasing inflation rates, this means that real interest rates are even higher than nominal rates, which further constrains access to credit.

Because boosting market confidence was critical given the financial downturn, fiscal discipline was essential. A potential step towards affirming a commitment to fiscal discipline would have been a reform of the subsidy system[3], which would have minimal impact on domestic demand and inflation given the fall of fuel prices. To be acceptable, additional fiscal

[3] Subsidies cost the government 3½ of GDP in FY 2008/2009. The reform could have eliminated subsidies on fuel, diesel, and LPG, and improved targeting for kerosene, food and fertilizers.

measures would have to be more efficient, directed towards financing projects, or aimed at raising the incomes of the poor. However, as of August 2009, the government had delayed cutting subsidies.

Regulatory reforms are needed according to the IMF. The predictions made by the RBI on the likely percentage of NPAs in the banking sector (to determine capital needs) were based on India's experience in the 2002/2003 downturn. However, should the value of NPAs rise by more than 200%, private money might be needed for additional recapitalization. Since 70% of all banks are public, enabling the flow of private funds into the system would require the removal of the current majority government ownership requirement. Similarly, removing the 10% cap on foreign investor voting rights would be required to raise private funds[4].

Financial information should be disclosed. Information gaps did not allow for a comprehensive assessment of risks in the financial sector. Data about foreign exposure, derivative positions (for both banks and corporates) and other key indicators of systemic financial risk should be made available to enable monitoring and multifactor stress testing.

Other structural and cyclical changes are needed. They include developing the corporate bond market, further liberalizing the capital account, and increasing banking sector efficiency through increased participation of domestic private and foreign investors. However, because India weathered the crisis better than other Asian nations and because of resistance on the part of core Congress supporters, significant structural economic reforms seem unlikely in the near future.

[4] Another reform would be to remove several restrictions on the NPA market to facilitate their disposal, such as allowing foreign investment in asset reconstruction companies (ARCs) as well as allowing non-bank but financially secure creditors to participate in the NPA market

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