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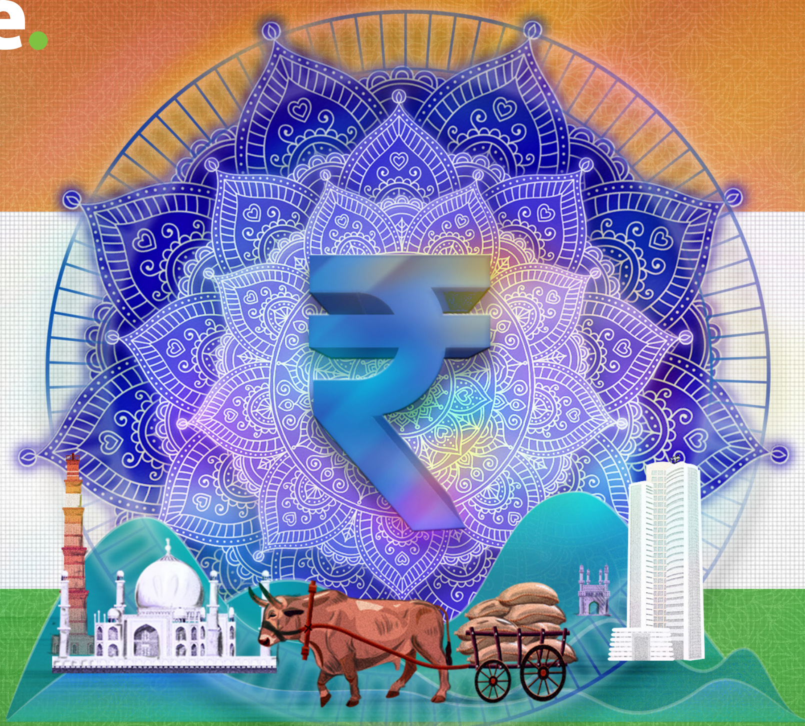


India

The economy gathers momentum, but headwinds could interrupt the rebound

By: Rumki Majumdar

India seems to be on a sustainable rebound after a year of uncertainty and slow growth. Last year, when the world packed a punch, growing at the fastest pace in five years, India's economy temporarily "decoupled," with growth decelerating to a four-year low.

The introduction of a new tax regime in the form of the comprehensive goods and services tax (GST) while the country was still experiencing the impact of demonetization affected not only growth but also prices and imports due to supply chain disruptions.

The latest GDP release has come as a relief to investors who have been concerned about India's lackluster performance because of these disruptions. The economy appears to be gradually consolidating the gains from recent reforms and bank

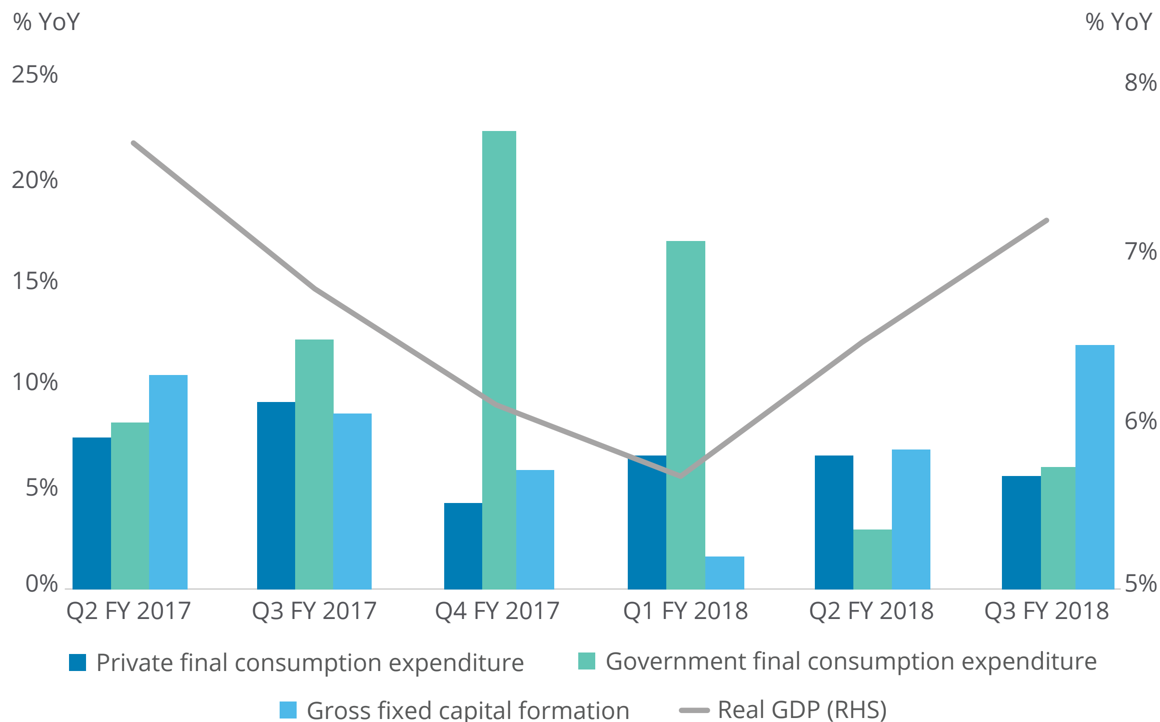
restructuring. With a steady improvement in world demand, increase in foreign direct investment (FDI) inflows, and the turnaround in domestic industrial production and vehicle sales, India will likely register 6.7 percent growth this fiscal and 7.2 percent in the next.[1]

While the economy has perhaps turned the corner and economic fundamentals look strong, it might be too early to celebrate. Significant headwinds still exist in the form of rising oil prices, increasing real interest rates and bond yields, worsening bank balance sheets, weakening trade, and pressure on the currency. Potential fiscal slippage due to impending elections this year and the next, and rising yields can impact capital flows and investment.

Growth finally rebounds

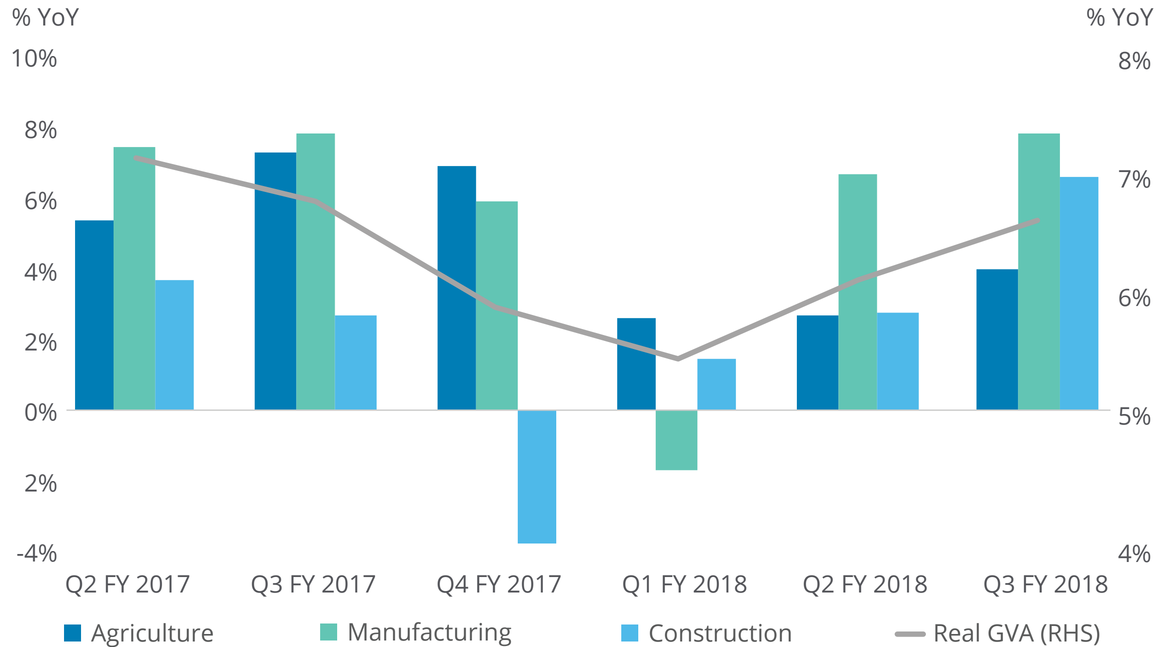
GDP accelerated from an upwardly revised 6.5 percent year over year in Q2 FY 2018–19 to 7.2 percent in Q3.[2] GDP growth in the corresponding quarter of the previous year was revised down, the result of which was a favorable base effect, with the economy witnessing all-round growth this quarter. On the demand side, growth in gross fixed capital formation built on the momentum it gained during the previous quarter and increased sharply by 12.0 percent (figure 1a). This is particularly important because investment in India has remained low for long and the nascent recovery that began in 2015 was cut short because of the twin impact of demonetization and GST implementation. Although a few quarters' data isn't enough to gauge the sustainability of an investment rebound, it is encouraging news. Private domestic consumption remained robust at 5.6 percent, although it fell from previous quarters. Exports remained a concern as they fell sharply despite improving global demand. Strong imports, combined with poor exports, weighed on growth and the current account.

Figure 1a. Growth appears to be rebounding: Domestic demand, expenditure side



Source: Center for Statistical Organization, sourced from Haver Analytics. **Deloitte Insights | deloitte.com/insights**

Figure 1b. Growth appears to be rebounding: Domestic demand, production side



Source: Center for Statistical Organization, sourced from Haver Analytics. **Deloitte Insights | deloitte.com/insights**

The production side of the economy, measured by gross value added (GVA), reflected softer growth relative to the expenditure side. That said, it accelerated from 6.2 percent in Q2 FY 2018–19 to a four-quarter high of 6.7 percent in Q3 (figure 1b). The agricultural sector registered strong growth of 4.1 percent and public administration, defense, and other services, a surprising 7.2 percent. The manufacturing and construction sectors registered strong growth of 8.1 percent and 6.8 percent, respectively, indicating that the sectors have probably shrugged off the teething troubles of GST implementation. Core GVA growth (nonfarm nongovernment GVA), which is often used to gauge underlying private sector growth, accelerated from 6.9 percent in Q3 to 7.4 percent in Q4, the highest growth since demonetization (figure 1b).

Recent monthly indicators suggest that growth might firm up in the current quarter as well. The industrial production (IP) index has been recovering in recent months, with capital goods production showing a sustained recovery. Both consumer durables and nondurables indices gained sequentially, indicating strong urban and rural demand.

The balance of risks

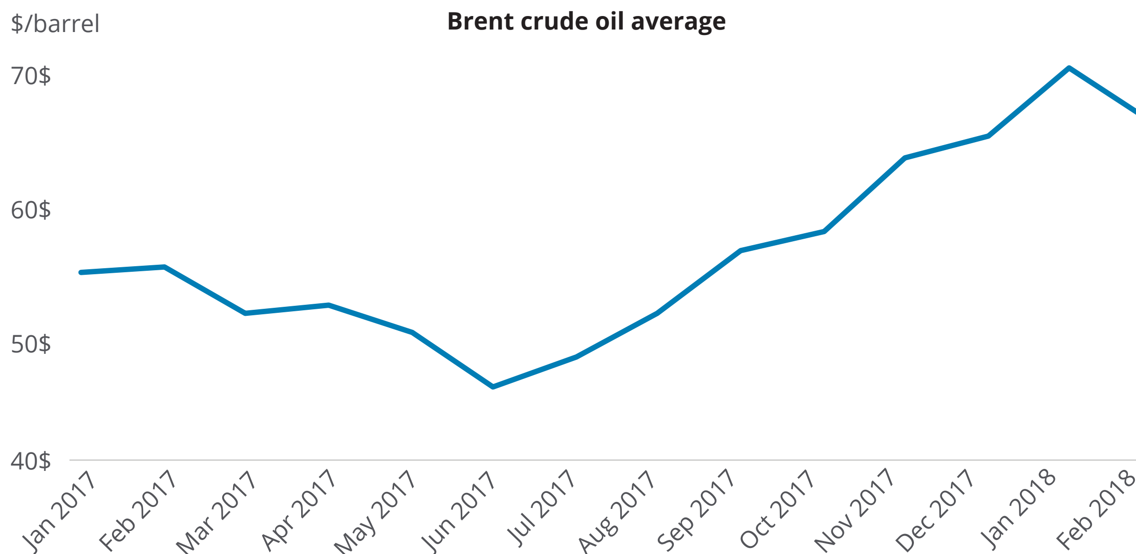
India's $2.5 trillion economy is expected to rebound in the next fiscal year and is soon expected to become the fifth-largest economy. However, the path to recovery is likely not going to be hurdle-free, as significant risks may lie ahead.

OIL PRICES

Oil prices have increased by over 40 percent in the past two quarters because of the combined effect of a pickup in global demand, tightening supplies due to production cuts by the Organization of the Petroleum Exporting Countries (OPEC), and declining crude oil inventories in the United States. This likely does not bode well for India, a net importer of oil. High oil prices not only increase the probability of a fiscal slippage, a larger current account deficit, and higher prices, but may also impact growth turnaround.

According to an estimate by the Reserve Bank of India (RBI), if crude oil prices (Indian basket) increase by $10 from the baseline assumption of $55, inflation could be higher by 30 bps and GDP could

Figure 2. Oil prices have gone up since August 2017



Source: Energy Information Agency and *Wall Street Journal*, sourced from Haver Analytics.

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fall by 15 bps.[3] Since the publication of the report, oil prices have gone up to $70 in January before easing slightly to $65 in February. If geopolitical developments disrupt oil supply while global demand continues to remain robust this year, oil prices might go north, putting pressure on inflation and growth. If oil prices remain at around $70–75 this year, it could push up inflation by half a percentage point and cause growth to fall by a quarter of a percentage point owing to higher input costs. That said, there will be an upper ceiling to rising prices due to increased US crude oil production, which has already broken the 47-year-old monthly oil production record last November.[4]

TRADE DEFICIT

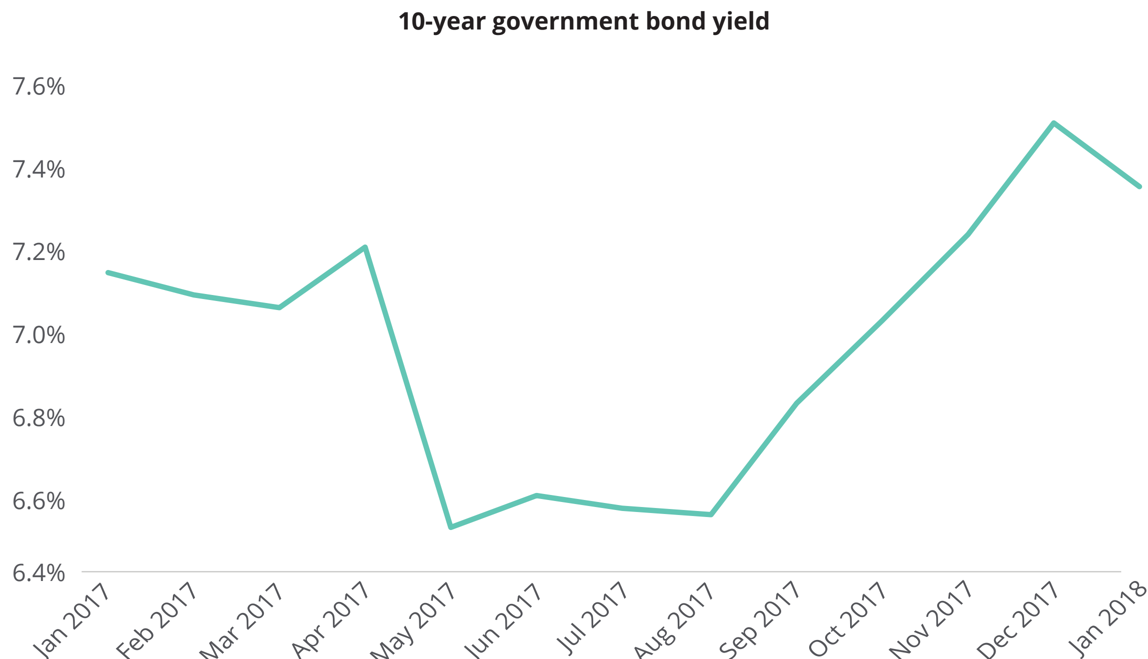
India's import bill has been climbing steadily with no cushion from exports to offset the impact, resulting in a wider trade balance. India's trade deficit in January surged to a five-year high of $16.3 billion. While rising oil prices contributed significantly to increased imports, a large part of the deficit was due to increasing non-oil non-gold imports owing to firming growth and GST-attributed supply chain disruptions. On the other hand, exports have failed to match the increase in imports despite rising global demand. Exports of services firmed up, but the rising deficit in merchandise trade outweighed the improvement.

A fall in oil prices and non-oil non-gold imports in February with sharply rising services exports improved the current account deficit last month, raising hopes that the external account might not be as bad. However, the current account deficit is likely to increase to -2.0 percent in FY 2017–18, up from -0.7 percent in FY 2016–17, and will be the highest since FY 2012–13.[5] A widening current account deficit likely does not bode well for the domestic currency, which has been steadily appreciating, impacting export competitiveness. Risks to export growth are to the downside, with prospects of rising protectionism and trade barriers impacting global trade and demand.

RISING BOND YIELDS

Ten-year bond yields have climbed up to a seven-year high, given the increased government borrowing (both center and state), the asymmetry in liquidity management by the RBI, rising oil prices, the government's PSU recapitalization, and a likely

Figure 3. Bond yields have increased since August 2017



Source: The Reserve Bank of India, sourced from Haver Analytics.

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shortfall in GST (figure 3). Global factors have also been at play with the US Federal Reserve expected to raise policy rates as the labor market tightens and inflation expectations firm up.

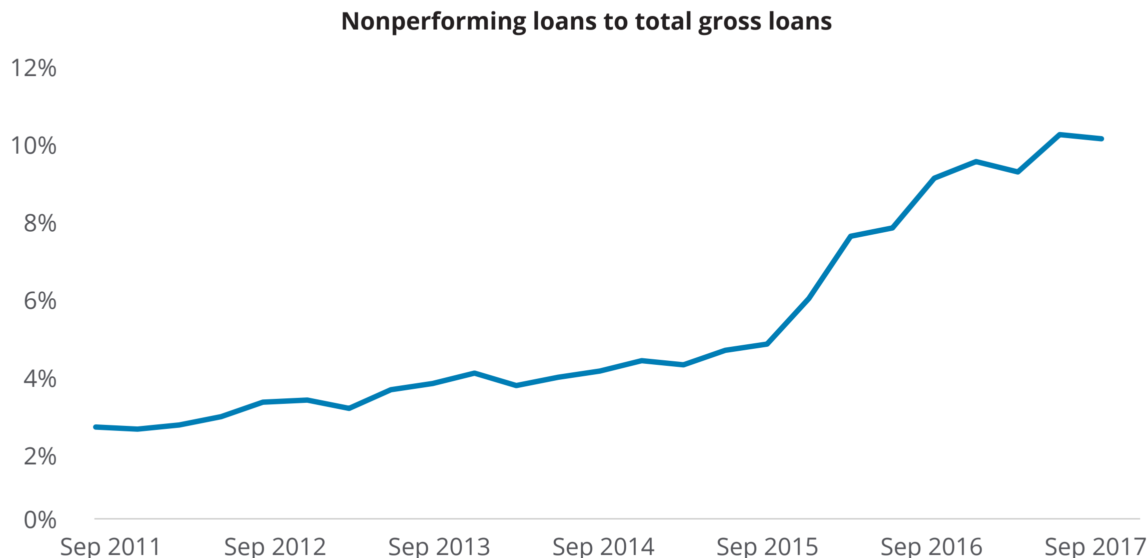
After the 2008 crisis, credit to the nonfinancial corporate sector has gone up sharply due to high global liquidity, resulting in strong capital inflows.[6] With yields shooting up, the cost of corporate borrowing has increased as corporate bond yields are on the rise. In addition, rising yields can make it difficult to service corporate debt and are expected to put highly leveraged corporate balance sheets at risk. With banks lending cautiously due to rising corporate defaults, there can be a downside risk to investment growth, corporate profitability, and business confidence.

FRAGILE CORPORATE AND BANKING BALANCE SHEETS

In November 2017, Moody's upgraded the Government of India's local and foreign currency issuer ratings to Baa2 with a stable outlook from Baa3—the lowest investment-grade rating—owing to economic and institutional reforms. The announcement came right after the government's announcement to recapitalize public sector banks and resolve high nonperforming loans using the Bankruptcy and Insolvency Act. Investors hailed the decision, which, it is assumed, will improve the banking system's functioning, increase lending, and raise investment.

While the reforms are still under way, one banking scam after another has eroded confidence in the banking system, as these events put further pressure on nonperforming assets (NPAs). As per the stress tests (*Financial stability report*, RBI, 2017), in the baseline scenario, gross NPAs of the banking sector rose from 9.6 percent in March 2017 to 10.2 percent in September 2017 and are expected to rise further (figure 4).[7] The stress is likely to come from corporate balance sheets that are highly leveraged and are unable to service their debt. With banks expected to deleverage their balance sheets in coming months and the RBI likely to tighten its supervision on the functioning of banks, the lending process will be impacted, resulting in lower investment.

Figure 4. Nonperforming loans have been rising sharply since 2015



Source: International Monetary Fund, sourced from Haver Analytics.

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FISCAL CONSOLIDATION

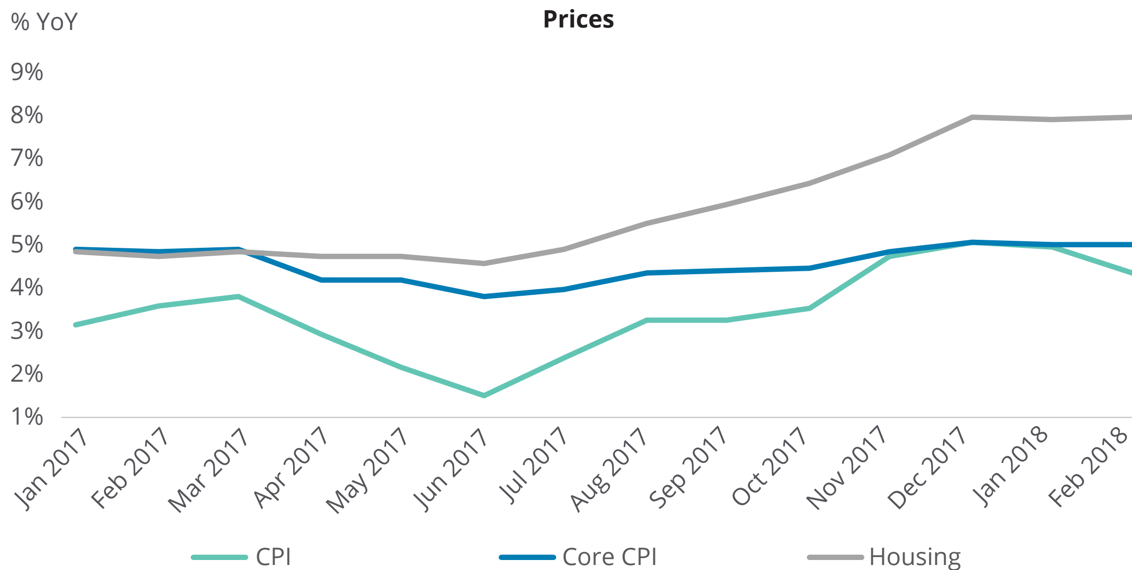
India has done a commendable job of consolidating its budget deficit, which has steadily declined over the years. However, this year, there is a shortfall in nontax revenues, which has offset the healthy rise in tax revenues. Consequently, the government has estimated that the fiscal deficit in FY 2017–18 will be 3.5 percent of GDP, up from the budgeted estimate of 3.3 percent. Also, the path to reach the target of 3.0 percent has been extended. There are downside risks to further fiscal slippage in the next fiscal year, given that 2018 is a pre-election year. Increased expenditure toward rural and urban development and oil subsidies could impact sentiments and raise bond yields further.

INFLATION

The other challenge is that prices have started edging up since November 2017. Even if one attributes this to the volatility in food and energy prices in recent months, prices excluding these—referred to as core prices—too have been increasing at a faster pace of over 5.0 percent. While supply chain disruptions following GST implementation played a role in pushing up prices, increase in human resource allowances (HRA) for government employees under the Seventh Central Pay Commission (CPC) award have resulted in a substantial rise in house prices.

Overall, prices in the coming quarters will depend on several factors. While inflation might ease as the impact of HRA and GST softens, there are risks to the downside as economic growth gains momentum. The recent fall in food prices may reverse during summer. Any increase in minimum support prices (1.5 times the cost of production, though there is some ambiguity in how the costs will be calculated) as promised in the budget and inadequate rainfall during monsoon may further increase food prices. So far, the increase in oil prices has had a muted impact on transport and communication because of a restricted pass-through to consumers. If oil prices continue to charter at or above $70 per barrel, it will likely push up inflation. Fiscal slippage could further add to inflation. The other risks are expectations of a rise in input costs owing to higher commodity prices, the staggered impact of HRA increases by various state governments this year, and the ability of producers to pass on input cost increases to consumers.

Figure 5. Prices are going up, with house prices registering a steep rise



Source: Ministry of Statistical Programme Implementation, sourced from Haver Analytics.

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Policies amid challenges

A combination of the aforementioned challenges has severely restricted the flexibility of both monetary and fiscal policies.

If oil prices continue to linger at $70 per barrel, fiscal and current account deficits will likely restrict the government's ability to undertake proactive stimulus programs to boost the economy. Any fiscal slippage in the next fiscal year could impact macroeconomic stability, borrowing costs, and investors' confidence, and it could be a tightrope walk for the government.

On the other hand, a widening current account deficit and inflationary pressures limit the RBI's ability to ease monetary policy. Rather, the RBI will likely wait and watch until it sees sufficient evidence of further declines in consumer price inflation and inflation expectations as well as a sustained recovery of the economy.

One of the immediate ways India can strategize boosting growth is by improving exports, which have remained dismal despite the global economy performing at its best after recovering from the shocks of the 2008 crisis. India should take the

benefit of this opportunity of a synchronized global recovery as drags related to GST implementation fade away. The other important measure could be to ensure robust credit growth even as banks correct their balance sheets. The government will have an important mandate to consolidate fiscal balance to meet the year's target, or else it can have implications on investors' confidence and sovereign ratings. Despite risks, with prudent and vigilant policies and a steady flow of foreign investments, India can stave off the economic gales and boost its domestic growth.

A QUICK TAKE ON THE BUDGET

The finance minister (FM) made an attempt to put together a prudent and responsible budget, despite walking a tightrope. This being a pre-election year, the focus switched from ease of doing business to ease of living for the common man as the FM doled out several measures to boost infrastructure, agriculture, health care, education, jobs, and small and medium enterprises (SMEs), as was expected. Announcements such as increasing minimum support prices (MSP) and allocating funds for fishery development and animal husbandry are expected to boost agricultural and rural income and bring relief to marginalized farmers.

Although no tax cuts were announced for large corporates, a lower corporate tax rate of 25.0 percent has been extended to companies with a turnover of up to INR 250 crore for FY 2016–17. This could significantly boost jobs and investment, which have remained a laggard in India's growth story. Increased customs duty on certain consumer products, such as mobile phones and televisions, can potentially provide a fillip to the Make in India initiative and encourage domestic production.

The government's continued efforts to further enhance the Digital India initiative are likely a step in the right direction. A substantial allocation under the telecom infrastructure, continued efforts to connect 1.5 lakh more villages under BharatNet initiative, setting up hotspots and accelerating the pace of 5G adoption, and promoting research in the field of artificial intelligence could be game changers for the economy.

The government revised this year's fiscal deficit up to 3.5 percent of GDP at INR 5.95 lakh crore. This was expected given the increased borrowing by the government in the past few months and lower-than-expected revenues from both direct and indirect taxes, not to mention the GST revenue that will be received only for 11 months. But it is comforting that the FM has decided to continue on the path of fiscal prudence and cap its fiscal deficit to 3.3 percent in FY 2019–20. It was no easy task given the pressure of increasing expenditure in a preelection year and rising oil prices pushing up fuel and fertilizer subsidy. With limited leg room to cut expenditure, the only way for the government to consolidate its deficit is through asset sales, and it has already announced the strategic divestment of 24 public sector units.

In what could be a double whammy for the salaried middle class, no change in personal income tax has been announced, while cess on income tax has been hiked by a percentage point to 4.0 percent for all categories of taxpayers. In addition, a 10.0 percent levy on capital gains of over INR 1 lakh (without the benefit of indexing) has been imposed with no relief on short-term capital gains. The only respite is the reinstallation of the standard deduction of INR 40,000 for transport and medical reimbursement.

Overall, being the fifth and final full budget of the present government, the FM has managed to balance populist demand and inclusive growth, and focus on fiscal consolidation. It is a *roti*, *kapada*, and *kisaan* budget,[8] and the government has continued its efforts to increase productive investments and implement structural reforms. Its resolve to improve the environment for doing business and willingness to consolidate its fiscal balance can go a long way in improving investors' confidence and in achieving growth of 8.0 percent and above.

ENDNOTES

1. Deloitte Insights, “Economic outlook: India,” *Voice of Asia*, March 13, 2018.
2. Growth is measured year over year unless specified otherwise.
3. The Reserve Bank of India, “Fourth bi-monthly monetary policy statement: 2017–18,” RBI Bulletin, October 2017.
4. Robert Rapier, “US breaks 47-year-old monthly oil production record,” *Forbes*, March 1, 2018.
5. Sourced from the Reserve Bank of India database, March 2018.
6. Rumki Majumdar and Akrur Barua, *Are emerging economies prepared as the global liquidity tap turns off?,* Deloitte Insights, March 13, 2018.
7. The Reserve Bank of India, *Financial stability report,* issue no. 17, December 2017.
8. This suggests the budget is aimed at the grassroots level, focusing on basic needs such as food *(roti)* and clothing *(kapada)*, and targeting improvement in the economic conditions of farmers *(kisaan)*.

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Rumki Majumdar, Deloitte Services LP, is a manager and economist who contributes to thought leadership on several contemporary economic issues related to the United States, India, and emerging markets. She analyzes economic and financial trends with policy implications on global businesses, and does macroeconomic forecasting.

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