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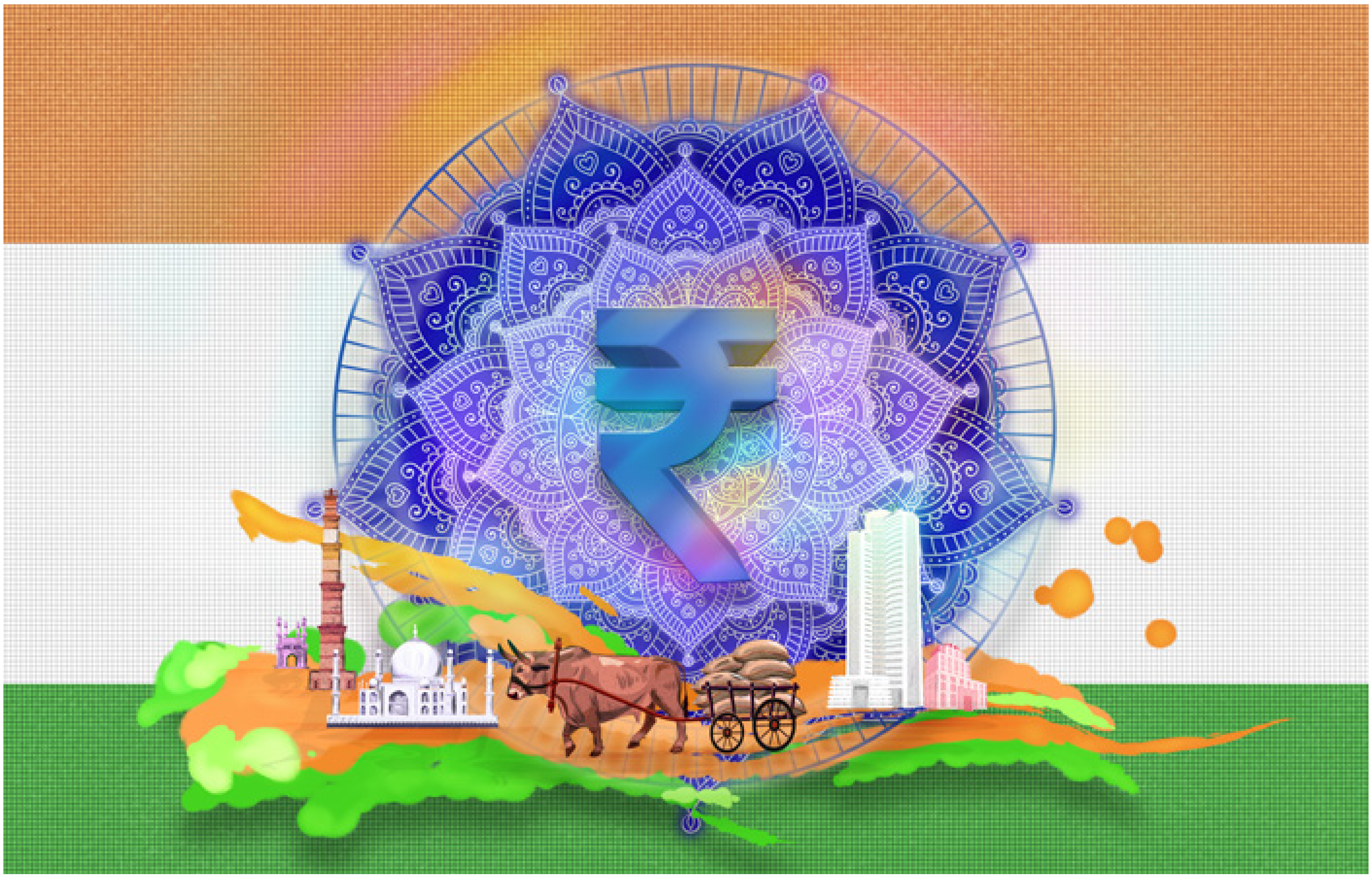


FEATURE

India

Economy needs increased private investment and fiscal prudence

Anis Chakravarty and Umang Aggarwal

The outlook is positive for India, one of the fastest-growing economies. Fostering private investment and careful management of public finances could help the economy go a long way.

THE INDIAN ECONOMY started the fiscal year 2018–19 with a healthy 8.2 percent growth in the first quarter on the back of domestic resilience. Growth eased to 7.3 percent[1] in the subsequent quarter due to rising global volatility, largely from financial volatility, normalized monetary policy in advanced economies, externalities from trade disputes, and investment rerouting. Further, the Indian rupee suffered because of the crude price shock, and conditions exacerbated as recovery in some advanced economies caused faster investment outflows.

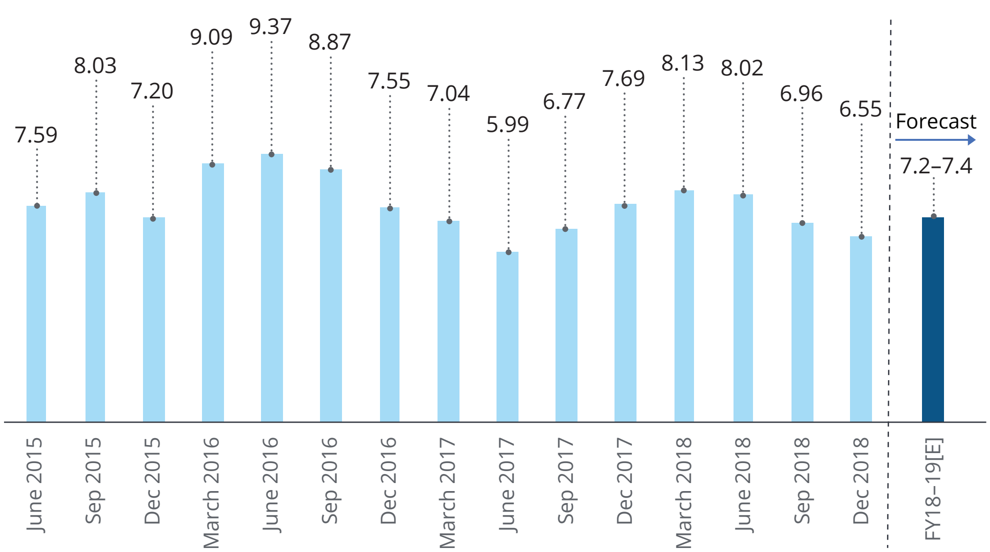
Despite softer growth, the Indian economy remains one of the fastest growing and possibly the least affected by global turmoil. In fact, the effects of the aforementioned external shocks were contained in part by India's strong macroeconomic fundamentals and policy changes (including amendments to the policy/code related to insolvency and bankruptcy, bank recapitalization, and foreign direct investment).

The Indian economy is likely to sustain the rebound in FY2018–19—growth is projected to be in the 7.2 percent to 7.5 percent range and is estimated to remain upward of 7 percent for the year ahead (figure 1).[2] These projections could be attributed to the sustained rise in consumption and a gradual revival in investments, especially with a greater

FIGURE 1

The Indian economy could sustain its rebound in FY2018–19

Real GDP growth rates (quarterly percentage change, year over year)



Note: Estimates for 2018–19 have been taken from the budget.

Sources: CEIC; Deloitte.

focus on infrastructure development. The improving macroeconomic fundamentals have further been supported by the implementation of reform measures, which has helped foster an environment to boost investments and ease banking sector concerns. Together, these augur well for a healthy growth path for the economy. India has already surpassed France to become the sixth-largest economy. By 2019, it may become the fifth-largest economy,[3] and possibly the third-largest in 25 years.[4]

Despite the positive outlook, the economy remains vulnerable to domestic and geopolitical risks, especially economic and political changes that can affect relative prices and hurt current and fiscal account deficit. While expectations of inflationary pressures remain benign, concerns have risen on the twin deficit problem—current account deficit and fiscal deficit—especially as portfolio investments remain subdued while trade deficit stays high. While fiscal expansion remains key to accelerating growth, it may weigh on government coffers if private investment loses steam.

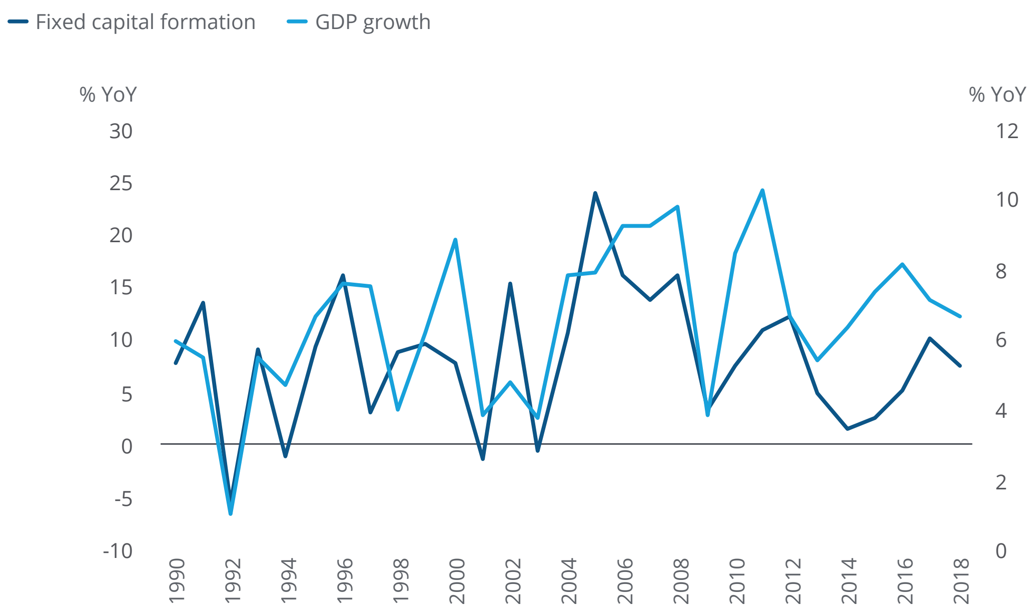
The time for increased private investment is now

With key economic policies on track, the government is likely to focus on faster policy implementation in the year ahead, with a greater focus on infrastructure development. Government push may encourage muted private investors to participate, thereby fostering private sector expenditure and boosting investments. On the flip side, however, increased borrowing by the government may reduce the pool for the private sector to borrow from, stalling any expansionary strategies. That being said, we believe that a key step toward healthy economic growth lies in reviving private sector investment, given that these have remained at low levels over the past several quarters.

Investments and growth follow a similar pattern, and investments make up a crucial component for overall growth optimization. Historical evidence demonstrates the importance of higher investments to achieve a sustainable higher trajectory for growth (figure 2). Capital formation peaked at 17.5 percent

FIGURE 2

High investments lead to growth improvement



Sources: CEIC; Deloitte.

during the mid-2000s (2004–08) from 5.1 percent during 1990–1995, which corresponded with the period of higher growth. However, the pace of growth in capital formation slowed thereafter to 4.3 percent during 2012–16 and has only recently started showing signs of improvement, rising to 7.6 percent in FY2017–18.[5]

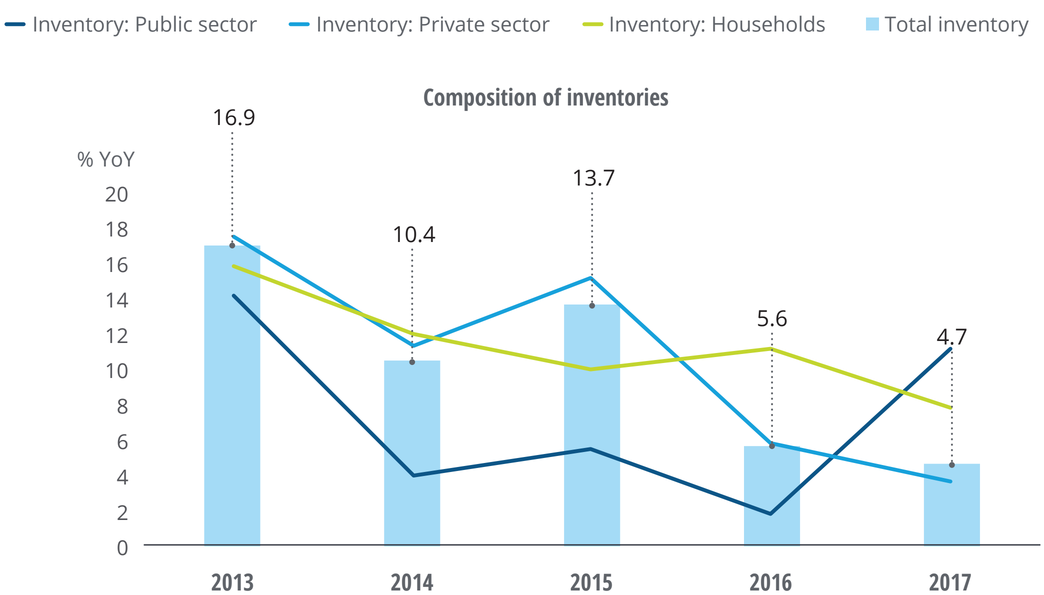
There is a gap in incremental investments (inventories) by public and private sectors—while inventories for the public sector have improved, those for the private sector have remained largely subdued (figure 3). A breakdown of the composition reflects that over the years, the increase in public spending has maintained the pace of overall investment increase, while the contribution from household and private sector has remained low. In fact, while public sector investment improved across the manufacturing segment, private sector investment has seemingly decelerated over the years. Perhaps overleveraged private sector balance sheets and higher cost of capital have deterred private players from entering the investment cycle. The share of gross capital formation has come down to 31 percent of GDP in FY2017–18 from about 34 percent of GDP in FY2012–13,[6] driven mostly by government intervention and capital flows. This suggests that the recovery is lagging due to the absence of private investments, and is sustained to a degree only through partial mediums, i.e., government investment and capital flows.

Increasing risk to government coffers

While higher government investments have helped retain a somewhat healthy sentiment for capital formation, the stretch in government expenses has already become evident in the expansion of fiscal deficit net. The fiscal deficit target was amended previously, but the recent budget announcement expanded it further to 3.4 percent of GDP for both FY2018–19 and FY2019–20 (from 3.3 percent and 3.1 percent earlier, respectively;

FIGURE 3

Government investment has maintained capital formation, but private investment has room to pick up



Sources: CEIC; Deloitte.

figure 4).[7] This became necessary given the expected higher expenditure toward income support scheme for farm households, pension scheme for the unorganized sector workers, and income tax rebate.

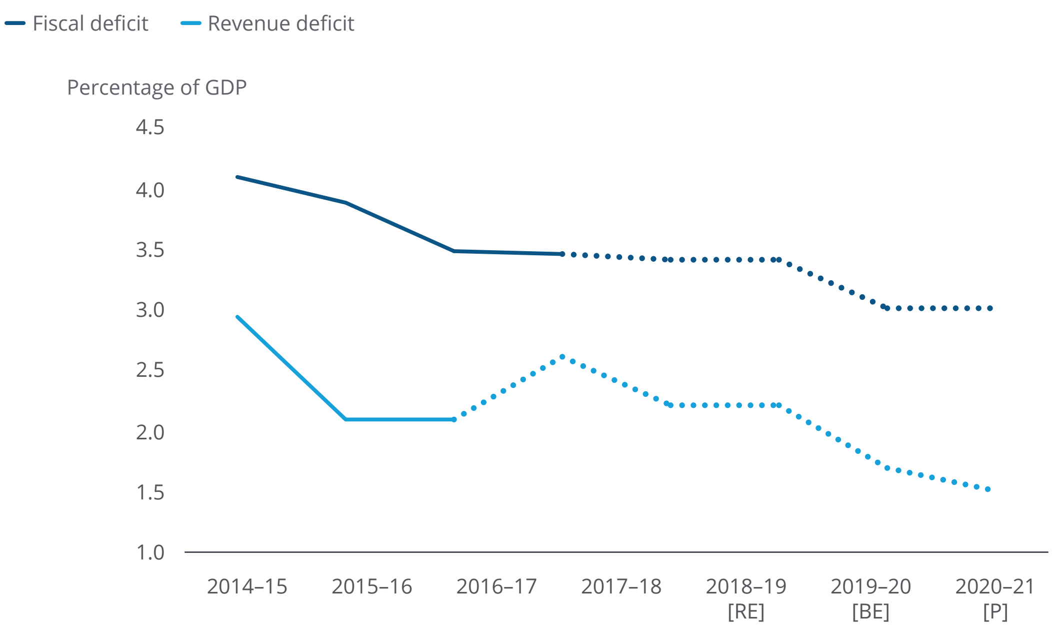
Gross general government debt, which reflects the sustainability of government finances, stood at 70 percent at the end of 2017 and is only expected to marginally soften over the coming years, depending on how the macroeconomic and investment situation develops. While most of the government debt is domestic, it remains a cause of concern, especially given that it is higher than most of the other Asian economies.[8]

Concluding remark

There is no doubt that India's recent budget has tried to strike a balance between fiscal prudence and growth. However, with risks looming large, India needs to solidify its investment position while maintaining fiscal deficit within the target range. The need to remain steadfast on fiscal numbers has risen largely from the need to stimulate growth amid pressure to cut taxes, increased budgetary allocations to social sectors, and enhanced infrastructure spending that could pressure public finance. Therefore, meeting the revenue collection and disinvestment targets would be crucial to ensure the budgeted reduction in the fiscal-deficit-to-GDP ratio. Overall, the government could do well to carefully manage its public finances and shift focus to projects that can foster private investment. The real challenge is likely to arise from making the right policy decisions about the fiscal expenditure mix and incentivizing private players so as to avoid any long-term costs.

FIGURE 4

Government has lifted fiscal deficit targets to make room for additional expenditure



Note: RE, BE, and P denote revised estimates, budget estimates, and provisional as given in the budget document for 2019–20, respectively.

Sources: CEIC; Deloitte.

Endnotes

1. CEIC data and Deloitte analysis.
2. Ibid.
3. Yashwant Raj, "India is world's sixth largest economy at $2.6 trillion, says IMF," *Hindustan Times*, April 19, 2018.
4. *Hindu Businessline*, "Jaitley: India can become third-largest economy," January 23, 2018.
5. IMF, CEIC data, and Deloitte analysis.
6. CEIC data and Deloitte analysis.
7. Ministry of Finance, "Union budget," accessed March 25, 2019.
8. CEIC data and Deloitte analysis.

About the authors

ANIS CHAKRAVARTY is a partner and lead economist with Deloitte India. He brings considerable experience in advising companies in the European Union, India, and the United States on a number of issues related to economics and finance. Chakravarty has been the coleader of Deloitte's Global Economists Network, leading the intellectual property initiative in the Asia-Pacific region. He is a regular contributor to print and electronic media on various macroeconomic issues and trade policies. His views have been quoted by *Economic Times*, *Business Standard*, *The Hindu*, and *Financial Express,* amongst others. He has also appeared in *Bloomberg*, *Wall Street Journal*, and *New York Times*.

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