2018.08.03 (No.11, 2018)

Newsletter

Institute for International Monetary Affairs
公益財団法人 国際通貨研究所

Economic Issues Facing India before the Upcoming General Election

Akira Nakamura
Deputy General Manager and Principal Economist
akira_nakamura@iima.or.jp
Economic Research Department
Institute for International Monetary Affairs (IIMA)

1. Decline of the rupee and rise of oil price

The exchange rate of the Indian rupee (INR) strengthened its declining trend after the start of 2018 to fall to a record low of INR69.09 per US dollar on June 28. The rupee has been hovering around the low range in August. As is the case of other emerging currencies, the rise in the US interest rates was the major cause of the depreciation of the rupee, with the rise of oil price likely spurred the decline. The rise of crude oil tends to rapidly increase the imports of India as India is heavily dependent on imports for its energy consumption including crude oil.

Figure 1 shows the trade deficits divided into those related to oil and its product and other products. The trade deficits are on a rising trend since the latter half of 2017 mainly due to an increase in the deficits of oil related products.

In India which has a poor energy efficiency, higher oil prices easily lead to an accelerated inflation. Consumer inflation has been gradually rising, reaching a year-on-year increase of 5% in June 2018. By category, while food and beverage remain stable, fuel and energy expenses have accelerated its rise, exceeding the rise of the overall index (Figure 2).

Under such circumstances, the Reserve Bank of India, a central bank, decided to raise its policy rate on June 6 for the first time since January 2014, followed by another hike on August 1 at the second consecutive meeting.

Figure 1 : Trade Balance of India

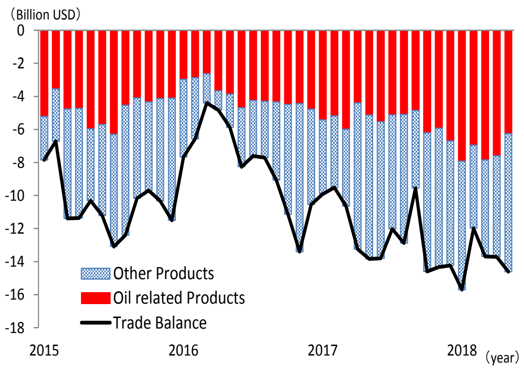
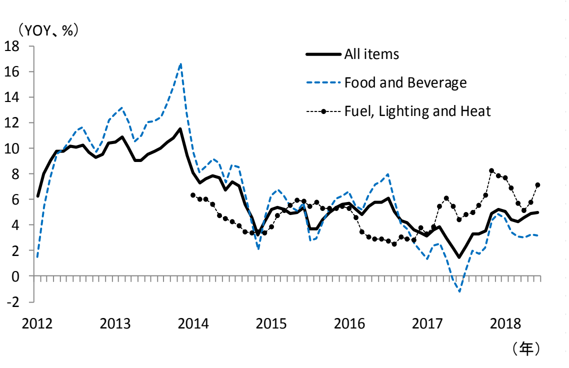


Figure 2 : Development of Consumer Prices



(Source) Reserve Bank of India

2. External Balance, international reserves and debt outstanding

The current account deficit started to increase in 2017 for the first time in three years mainly due to an increase of trade deficits. If the rise of crude oil continues, it is highly likely that the current account deficit will further increase in 2018 (Figure 3). Meanwhile, the foreign exchange reserves tended to increase up to the end of 2017, maintaining a relatively high level of an equivalent of 10 months of imports (Figure 4).

Figure 3 : Current Account of India

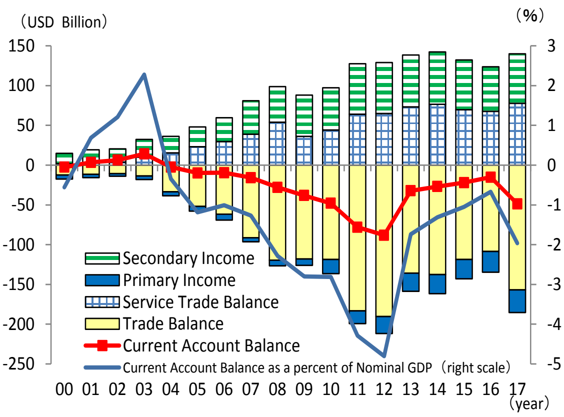
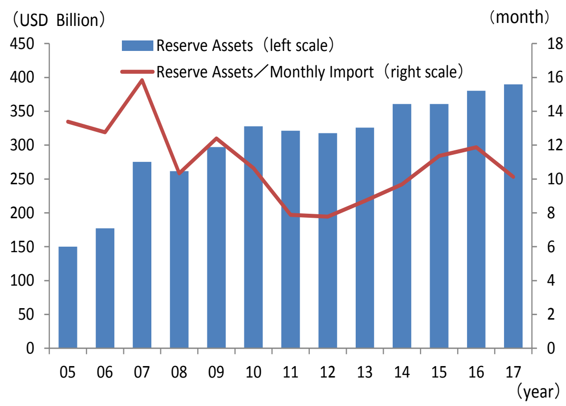


Figure 4 : Foreign Exchange Reserves and its Ratio to Imports



(Source) Reserve Bank of India

The external debt outstanding is relatively low as compared to its economy (GDP) together with a relatively small ratio of short-term external debts to foreign exchange reserves (Figures 5 and 6). Even if the current account deficit should expand in the future, it is unlikely that it will immediately raise a concern over India's capability to pay the external debts。

Figure 5 : Ratios of External Debts to Nominal GDP (%, end of 2017)

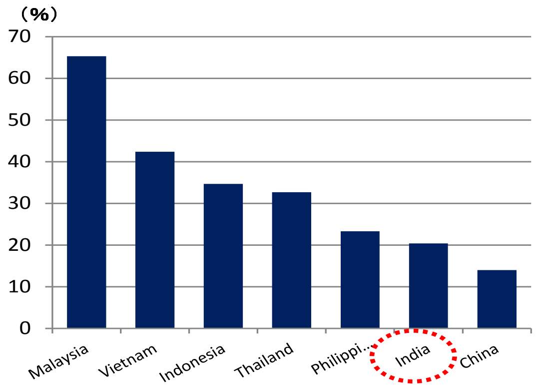
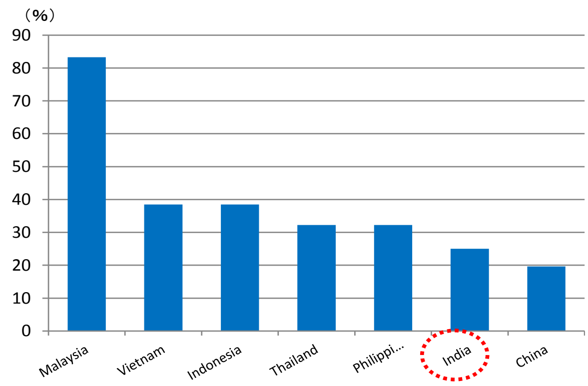


Figure 6 : Ratios of External Short-term Debts to Foreign Exchange Reserves (end of 2017)



(Source) Reserve Bank of India

3. No noticeable achievement in the "Made in India" policy by the Modi administration

Soon after its establishment of the government, the Modi administration announced a "Made in India" policy, a measure to foster manufacturing industry, to enhance its economic growth and increase employment. By aiming at raising the ratio of manufacturing in the economy to 25% by 2022, it revealed various measures to attract foreign investment including (i) introduction of bankruptcy and failure act, (ii) partial deregulation and simplification of procedures of the Labour Act and (iii) simplification of taxation system through the introduction of Goods and Services Tax (GST).

However, the result is not so good so far. The composition of real GDP by industry shows that the share of the manufacturing industry rose only 0.3% in the 3-year period from fiscal year 2014 to 2017 after rising 1.4% in the seven years from fiscal year 2007 to 2014 when the Modi administration was launched. There is no noticeable sign that the share of the manufacturing industry in the economy has risen substantially under the Modi administration (Table 1).

Foreign direct investment in India somewhat decreased for two consecutive years of 2016 and 2017 after recording an inflow of $44 billion in 2015, the largest in the past 10 years (Figure 7). Although the government has made efforts to improve the investment environment for foreign capital, its result seems to have been rather limited.

Table 1 : Composition of GDP by Industry

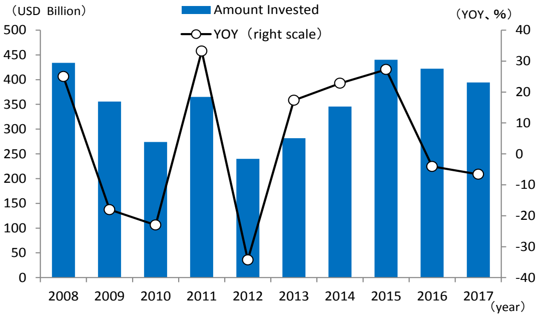
(in real terms)

(%)

	FY2007	2014	2017
Agriculture and Fisheries	16.8	15.4	14.6
Manufacturing	16.1	17.5	17.8
Construction	8.1	8.5	7.8
Service	54.4	53.4	54.8
Others	4.5	5.3	5.0
Total	100.0	100.0	100.0

(Source) Reserve Bank of India

Figure 7 : Foreign Direct Investment in India



(Source) Reserve Bank of India

4. Movement of the Modi administration for the general election slated for in 2019

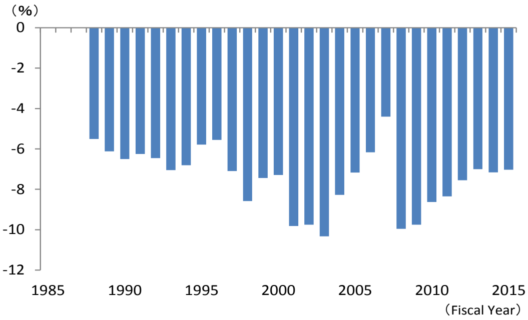
On May 12, an election was held for the Parliament of Karnataka State, which drew much attention as an event providing some prospects of the general election slated for in the spring of 2019. The ruling party Indian People's Party (Bharatiya Janata Party, BJP) substantially increased the seats to become a leading party but failed to gain the majority. The Indian National Congress decided to maintain the power in the State Parliament by forming a coalition with the Janata Dal (Secular) (JDS). Some view that the result of the latest election revealed that the leading opposition party "National Congress" has the ability to deal with the BJP in the future by coordinating between local political parties on the recruit of candidates and other matters of interest. If the opposition parties should strengthen their solidarity, it will pose a threat to the ruling party BJP in the election campaign. Given the stagnation of the government's important "Made in India" policy and a strengthened alliance of the opposition parties through local elections, Prime Minister Modi and his party BJP seem to be strengthening its crisis awareness.

Actually, the government, being conscious of the election, already started to take measures in the budget for fiscal year 2018 that started April to expand the support from regions, farm households, and the low-income class in the big voting blocs. Specifically, they included such measures to fight poverty as (i) an increase of subsidies for daily necessities to farm households and the low-income class, (ii) expansion of agriculture-related expenditures, and (iii) subsidies for medical expenses to the low-income class. For these, however, there is a voice of criticism that they are dole-out policies of the government aimed at the election, together with a rising concern about an expansion of the fiscal deficit.

The fiscal balance of India (general government) has already run a deficit exceeding 6% of nominal GDP, and an expansion of the fiscal deficit due to increased expenditures for poverty programs will further narrow the degree of freedom to take discretionary measures since India has relatively high public debt outstanding (Figure 8 and 9).

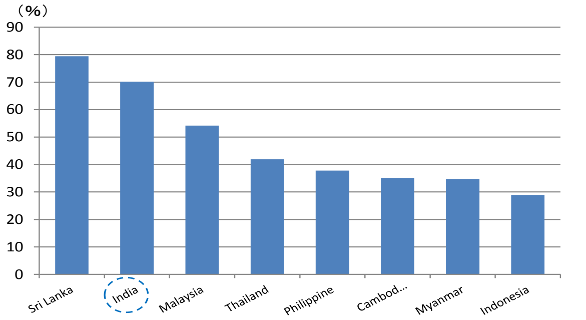
Figure 8 : Fiscal Balance of India

(% of nominal GDP)



(Source) IMF

Figure 9; Public Debt Outstanding of Asian Countries (% of nominal GDP, end 2017)



(Source) IMF, World Bank Database

5. Conclusion

The cheap oil prices prevalent until early 2016 benefited India, which is a big importer of crude oil, both in terms of price stability and reduction of the current account deficit. Currently, however, the rising oil prices have been apparently increasing the current account deficit and accelerating inflation, two risk factors that have been concerned hitherto. Yet, modest expansion of the current account deficit is not likely to raise an immediate concern over the external debt service as India's external debt outstanding is relatively small in proportion to both its economic size and international reserves.

On the other hand, a rise in consumer prices has been already accelerating, with further increase in inflation in prospect in the time ahead. The Reserve Bank of India expressed its concern over the rise in material costs including higher oil prices when it decided to hike its policy rate in June and concern over the overall price increase at the August policy meeting when it decided another rate hike.

The Indian economy has been performing well with real GDP growing by 7.7% in the January-March quarter of 2018, showing that the influence of elimination of high-denomination bank notes in 2016 and introduction of GST in 2017 are fading away. However, if the interest rates continue to be raised onward in the backdrop of an apparent acceleration of inflation, its adverse influence will be inevitably extended to the whole economy that is now growing strongly. It is also expected that the dissatisfaction of the nation will increase, and it will become a serious setback to the current administration ahead of a general election. In addition, there is a concern that a budget deficit might expand due to a decrease in revenues led by reduced tax collections, coupled with an expansion of budget expenditures for poverty measures, which will limit the fiscal space of the government. For the ruling party BJP, the risk factors that result from these economic conditions may pose a difficult problem on the government in fighting an election campaign in the environment of a reinforced unity among the opposition parties.

Address: 3-2, Nihombashi Hongokucho 1-Chome, Chuo-ku, Tokyo 103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町 1-3-2
電話：03-3245-6934（代）ファックス：03-3231-5422
e-mail: admin@iima.or.jp　URL: https://www.iima.or.jp