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Strong Indian Economy:
Its Backgrounds and Risk Factors

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Preface

The Indian economy has been enjoying a strong growth. In the past several years it has shown a marked strength among emerging economies, recording one of the highest growth in the world. Although the real GDP slowed down in the Jan-Mar quarter of 2017 to a growth of 6.1% as compared with the same period of previous year, falling from 7.0% growth in the previous quarter, the economy is expected to rebound after the April-June quarter, suggesting that the adverse effects of the abolition of high denominated notes have been ending in a relatively short period. On the political and administrative aspect, the ruling Indian People's Party (BJP) has been conducting stable policy management while keeping a solid political base. The implementation of Goods and Services Tax (GST) to unify into one the indirect taxes that differed among Provinces, which has been a long standing challenge for the Union government, finally came in sight, and progress has been seen in the simplification of tax systems that were unpopular among foreign companies. In this article, the author intends to review the backgrounds of the strength of the Indian economy and examine the risk factors that may affect the sustainability of the Indian economy.

1. Solid Economic Performance with Strongest Growth among Emerging Countries

Since 2014, the Indian economy has recorded strong growth mainly supported by robust private consumption and capital investment that were helped by price stability under the falling oil prices and fall in interest rates. The real GDP recorded high growth of 8.0% in FY2015 and 7.1% in FY2016 over the previous year, respectively[1]. Especially in 2016, it showed a marked growth of more than 7% in the backdrop of negative growth in resource rich countries of Brazil and Russia due to stagnant commodity prices while the Chinese economy grew by less than 7% for two years in a row. The current account deficits continued to decrease to 1.1% of nominal GDP in 2015.

The exchange rate of the rupee has been stabilized reflecting the strong economic fundamentals and a reduced risk for financing current account deficits. After the victory of Republican candidate Donald Trump in the U.S. presidential election, there was a global capital reflow to the U.S. on the expectation for its higher growth and higher interest rates through the increase in public investment and tax reduction promised by the new government. This caused depreciation of many currencies of emerging and developing countries, among which the fall of the Indian rupee remained relatively small. Since the beginning of 2017, the rupee has been continuing to follow a steady and solid path.

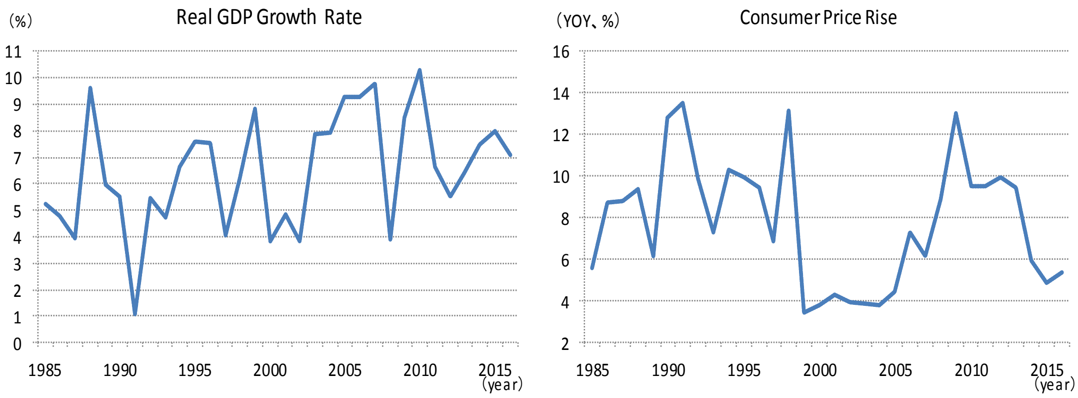
The main reason why the real GDP in 2016 sustained its high level of growth, albeit decelerating a bit from 2015, was attributed to the robust development in private consumption and government consumption. Private consumption gained its impetus helped by increased purchasing power due to stable price development and recovery of farm incomes. Government consumption was likely to be pushed up by the pay raise for government employees. Capital investment also kept its relatively steady development. Overall the domestic demand continued to increase briskly. The real GDP grew 6.1% in the Jan-Mar period of 2017, mainly reflecting slower growth in private consumption, slowing from 7.0% growth in the previous quarter. However, the growth rate is expected to reaccelerate in April-June quarter and after, and it seems the adverse influence of the currency exchange initiative (abolition of high value notes implemented in November 2016) has been short-lived and relatively mild.

Consumer Price has remained steady and stable. As there was a substantial rainfall in the rainy season of June to September 2016, causing no serious shortage of agricultural products, and the sagging oil prices are expected to continue for a while, it is highly probable that the price stability will continue[2]. Given the stable price development and sustained influence of

[1] Refers to a fiscal year that covers from April to the next March. Same applies below.
[2] IMF forecasts the rise of the CPI at 4.8% for 2017 and 5.0% for 2018.

easy monetary policy, the economy will continue to grow at around 7% from 2017 to 2018. Unless there are any exogenous shocks, possibility is high that the same degree of growth will continue even after that. The central bank estimates the potential rate of the Indian economy at 6.8%, and judging from this point, the growth rate expected above will be a reasonably sustainable level for the Indian economy[3].

Chart1 : Real GDP Growth Rate and Consumer Price Development



(Source) IMF and Reserve Bank of India

2. Eliminated Constraints against the Economic Growth—Inflation and Current Account Deficits

The inflationary tendency and large current account deficits which have been a long-standing problem to India have been gradually improved since 2014. Both consumer and wholesale prices remain on a stable course helped by a sagging oil price and the recent stability in food prices. The current account deficits, in the meanwhile, have tended to narrow mainly because of decrease in imports centering on oil and oil-related products due to the sagging oil prices. Falling oil prices have benefitted India both in terms of stable inflation and narrowing current account deficits.

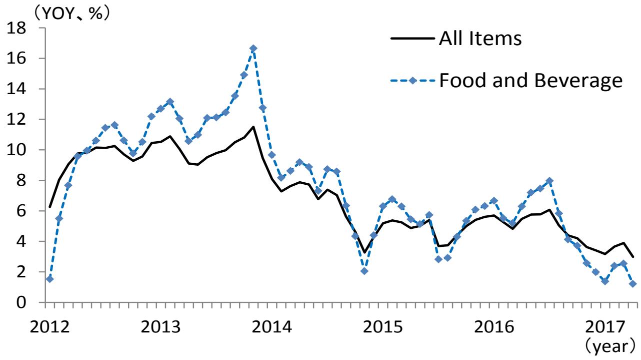
(1) Inflation Turns to be Stable

Consumer price continued to rise until 2013 at a speed to reach almost 10% level, but after 2014 it subsided reflecting the stagnant oil prices. In 2016, CPI tended to decline as the food price stabilized since August reflecting stable vegetable and fruit prices supported by sufficient rainfall in the rainy season of June to September. The stable development continued into 2017, with the CPI rise in April declining to 3.0% over the 12 months. (Chart 2)

[3] Reserve Bank of India Working Paper Series No.5/2016"India's Potential Output Revised" issued in April 2016

Agricultural products are expected to stabilize supported by the favorable rainfall in 2016. Continued stability in inflation will also be helped by the low prices in international commodity prices including oil and oil related products as oil prices are expected not to rise persistently in the foreseeable future. The relatively smaller fall of the rupee will also contribute to the stable import prices. Overall, the price development is estimated to remain on a stable trend for the time being.

Chart 2： Consumer Price Development

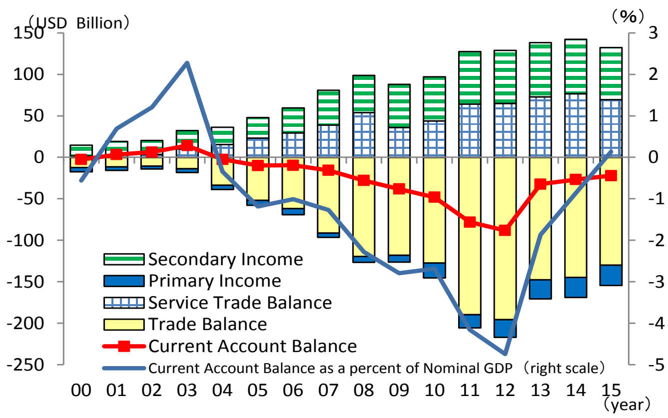


（Source） Reserve Bank of India

（2） Narrowing Current Account Deficits

The current account of India turned into deficit in 2004 mainly due to the expansion of a trade deficit. The deficit continued to expand to a 5% level against nominal GDP in 2012. (Chart 3)

Chart 3：Current Account Balance in India



（Source） Reserve Bank of India

Since 2013, however, the current account deficits continued to decrease to 1.1% of nominal GDP in 2015, as the services account surplus and secondary income surplus centering on overseas workers' remittances tended to increase while the trade deficits continued to decline. The decline of the trade deficits was mainly attributable in 2013 to the decrease of imports of gold due to restrictive measures with higher customs tariffs and since 2014 to the decrease of imports of oil and oil products helped by falling oil prices. In the months ahead, a large expansion of trade and current account deficits is hard to expect since the Indian exports will be on a rise following the mild recovery of the global economy while the decreasing trend of imports is likely to continue reflecting the oil prices expected to be sustained at lower level.

Moreover, while India's external debts have been mildly expanding, the ratios of its debt outstanding to nominal GDP and short-term debts to foreign exchange reserves remain at low level compared to other emerging countries. In this regard India has won a certain confidence of market participants, which seems to be underpinning the stable development of the rupee in recent months as compared to other emerging currencies.

Chart 4 : External Debt Outstanding
(% of nominal GDP)

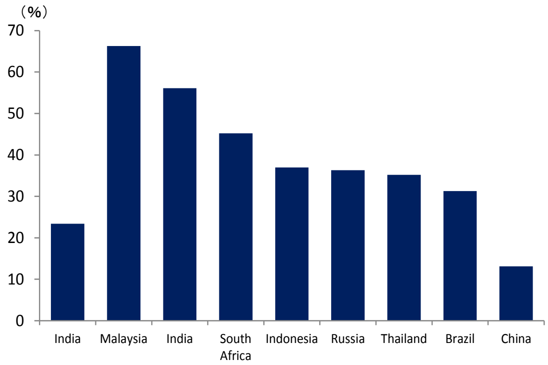
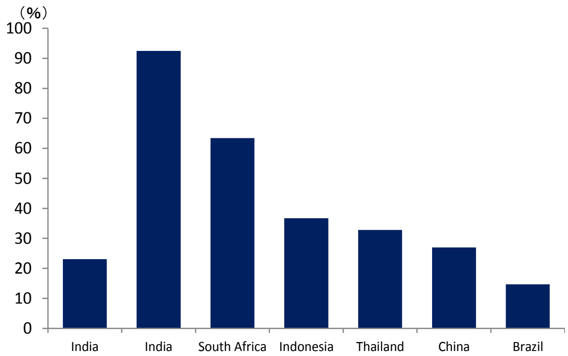
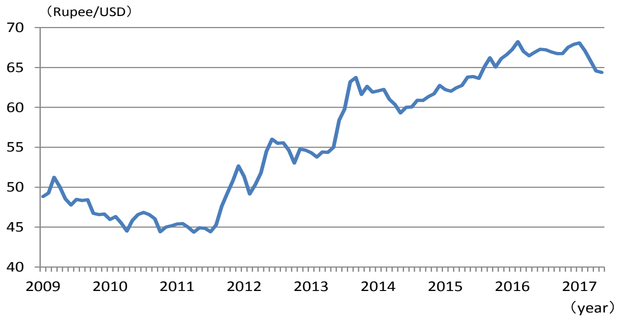


Chart 5 : Short-term External Debt Outstanding
(% of Foreign Exchange Reserves)



(Notes) As of the end 2015. The higher short-term external debt ratio to FX reserves represents a larger uncertainty over the foreign currency financing.
(Source) World Bank data.

Chart 6 : Foreign Exchange Rate of the Indian Rupee



(Source) Reserve Bank of India

3. Structural Reforms of Prime Minister Modi in his Two Years Term

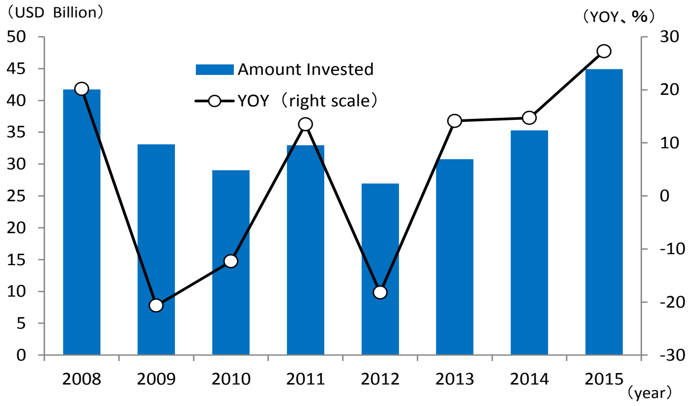
Three years have passed since Prime Minister Modi assumed the office in May 2014. He and the Indian Peoples Party set out a structural reform program to revitalize the Indian economy with its effort to make efficient policy management under a smaller government. The priority areas in the economic policies included (i) control of food inflation through agricultural reforms, (ii) improvement of business environment like tax system and labor laws, (iii) improvement of infrastructure, (iv) promotion of foreign direct investment in India, and (v) revitalization of manufacturing industry. Among these areas, progress has been seen in all items except (v) manufacturing industry, together with elimination of corruptions. It seems that the reforms have been assessed as achieving a significant result on the whole.

First, as for the reform on agricultural areas in (i) above, the administration decided to curtail the scope of raising minimum prices for buying out crops and later controlled the increase of domestic food prices, which are considered to have laid the foundation for the current price stability. The draft budget for FY2016 contained a taxation intended to agricultural development.

On the second item of tax system, introduction of the goods and services tax (GST), a long standing challenge for India, has been finally set. The GST is an indispensable policy measure that unifies the indirect taxes between the Union government and local governments and that simplifies the complicated taxation system in India. There have been strong requests by foreign companies including those from Japan, and therefore its progress affects the success and failure of the reforms themselves. Although the initial plan of introducing a unified single tax rate was postponed and replaced by a plan for applying 4 stages of tax rates ranging from 5% to 28%, it will realize a simplification of the current complex tax structure with over 15 kinds of tax rates into a single tax structure with four tax rates. With this simplification companies can expect a positive effect of reduced tax filing costs, which will likely improve the investment environment to the foreign affiliated companies. Although the revision of land expropriation law and labor law has yet to be seen, Insolvency and Bankruptcy Code was enacted in May 2016, steadily paving the way to a more improved legal environment.

As for the infrastructure improvement in (iii) above, progress has been recognized on the construction of highways and extension of existing roads. In the draft budget for FY2016, criteria for reviewing the contracts for the Public-Private joint projects have been incorporated to revitalize the infrastructure improvement. Among the infrastructure projects, both Japan and China seek to get acceptance of orders in the area of high speed railways, actively lobbying the government to give them a favor. Foreign direct investment in India (iv) increased for the past 2 years in a row, suggesting a positive effect of attracting foreign capital through infrastructure improvement. Foreign investment in India amounted to $44.9 billion in 2015, increasing by 27.3% over the previous year and recoding the largest amount since the global financial crisis of 2008. Especially investment from Singapore and Mauritius showed a big increase mainly because these countries were exempted from capital gains tax on their income transfers based on the bilateral tax treaties between them. (Chart 7)

Chart 7 : Foreign Direct Investment in India



(Source) Reserve Bank of India

On the other hand, there is no tangible result in the revitalization of manufacturing industry noted in (v), it is assessed. Although the government, under the slogan of “Make in India”, set out an objective to raise the ratio of manufacturing industry in the GDP from the current 16% to 25% by 2022, no new policies to stimulate the industry are announced.

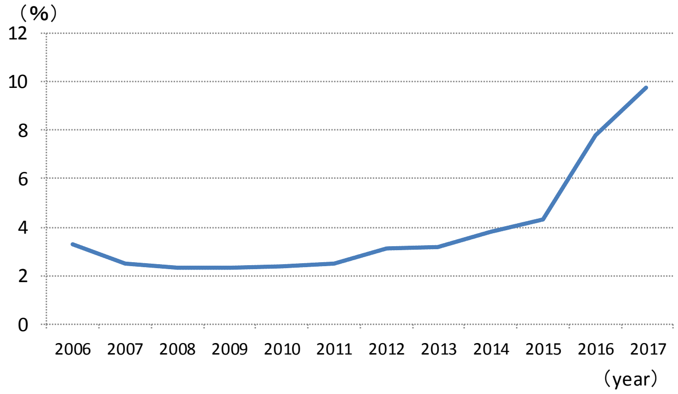
Summing up, the efforts of structural reforms under the Modi administration have achieved a certain level of results, which can be evaluated to have contributed to creating a basis for a strong growth of the real GDP that exceeded 7% in the three successive years from 2014 to 2016.

4. Non-performing Assets Problems of the Banks

In India non-performing assets of banks have been increasing, causing a problem in making loans to a part of industries and companies. Specifically serious are the public sector banks, with their loan extentions to large companies significantly slowing. According to the asset assessment by the central bank, Non-Performing Assets (NPA) ratio of commercial banks recorded a high level of 7.8% as of March 2016. The main reason is attributed to a weak loan assessment and inadequate credit risk management of the public sector banks. (Chart 8)

Reflecting the difference in the financial standing among the banks, a gap is occurring in the pace of increase in lendings between the public sector banks and private banks. The public sector banks have suffered from worsening in their balance sheets saddled with a high NPA ratio and the increase in their lending is slowing as a whole because the majority of their lending is directed toward companies who have relatively moderate increase in demand for funds. On the other hand, private banks are increasing their lending pace since they have a stronger balance sheet and their lending is mainly directed to retail sector who has a solid demand for funds.

Chart 8 : Non-Performing Assets Ratio of Indian Banks



(Note) Ratio of non-performing assets in total lending. Actual results as of every March. Estimate for the figure for 2017.
(Source) Reserve Bank of India

The Reserve Bank of India estimates that the NPA ratio will continue to rise for a while. According to its financial stability report issued in December 2016, the NPA ratio is forecasted to rise up to 10.1% by March 2018, after recording 9.8% in March 2017. By industrial groups, the ratio in such sectors as steel, engineering and infrastructure, which have been positively financed under the infrastructure improvement policy by the government, is expected to reach higher levels.

Although the NPAs are at their worst as ever, they are believed to be safely managed through the early injection of public money, as the Indian economy is growing rapidly supported by private consumption and the share of the banking sector is still small in the economy. The government, based on the estimation that it would need a capital injection equivalent to 1.8 trillion rupees for a period of 2015-2018, has already injected in stages 0.7 trillion rupees excluding the fund of 1.1 trillion rupees that were raised independently by the banks. As the injection by the government of 0.7 trillion rupees accounts for only 0.4% of nominal GDP, hindrance, if any, to further increase of injection is likely to be small.

5. Consistency of Policy Stance after Retirement of the Former Governor Rajan

On September 4, 2016, the governor of the central bank Raghuram Rajan retired from the top post of the Reserve Bank of India, and his post was succeeded by the then deputy governor Urjit Patel. Mr. Rajan enjoyed a deep confidence of the market as an inflation fighter who was rather cautious to lower the interest rates than to promote growth. Therefore, when Mr. Patel, who was regarded as much closer to Prime Minister Modi, succeeded Mr. Rajan, there was a voice of concern from some market participants that the independence of the central bank and the restrictive monetary stance previously taken might be altered. The concern became stronger when the interest rate cut was decided at the monetary policy committee on October 4 against a backdrop of majority market expectations for no change of policy rates.

Nevertheless, since the governor Patel had taken charge of monetary policy including financial reforms and disposal of NPAs under the former governor Rajan, it is hard to consider that he suddenly turns to become a dove and continues to lower the interest rates aiming at underpinning the economy. In fact, the central bank decided to leave the rates unchanged at the monetary policy committee held on December 7. In February this year, the bank adjusted its monetary stance from easy money to neutral while maintaining its interest rates unchanged. Reflecting this cautious stance of the central bank against easier monetary policy, a sense of anxiety toward governor Patel has been gradually corrected. It can be judged, therefore, the risks are not so large that the central bank will shift away from its cautious anti-inflationary stance taken in the days of Mr. Rajan, or the bank is managed in a way that would impair its independence.

6. Influence of the US Trump Administration on the Indian Economy

The Unite States has been adopting a protectionist trade policy under the new Trump administration which came into office on January 20, 2017. President Trump had publicly stated that he would retrieve the trade surplus and jobs the US has lost due to a free trade policy. At this point, however, it is unclear to what extent the administration can implement its protectionist policy. Further, the statements of President Trump suggest that its protectionist policies are targeted mainly to China and Japan, with no concrete reference to India. The U.S. trade deficit with India is comparatively small at $24.3 billion in 2016, which is less than a tenth of the U.S. deficit with China ($347 billion). Taking this into consideration, it is quite unlikely that India will be subject to notable sanctions.[4]

The manufacturing companies like major auto makers which have production bases in

[4] The deficit with Japan recorded $68.9 billion in 2016.

Mexico and export their products to the U.S. taking advantage of the NAFTA, including the US companies, are likely to be subject to a sanction of high tariffs depending on their behavior. However, differing from the U.S. and Japanese manufacturing giants like big auto makers, the number of the Indian companies that have a production base in Mexico is limited and therefore the impact of a sanction, if any, will be quite small.

In the meanwhile, the U.S. expressed its withdrawal from the Trans Pacific Partnership Agreement (TPP) that has already reached a broad agreement. As India did not participate in the TPP negotiations, there was a concern that the products of India might lose competiveness among the exports to the U.S. if the TPP took effect under the participation of the U.S. Therefore, the withdrawal of the U.S. from the TPP negotiations is highly likely to prove to be beneficial to India.

In these situations, what is seen most influential to India among the policies of the new U.S. administration will be a tightening of conditions for issuing H-1B visas to foreign workers in specialty occupations. Indian workers account for more than half of issuance of such visas. If the U.S. IT companies happen to face difficulty by the unavailability of Indian technical experts, the IT related exports of India to the U.S. will be adversely affected.

In general, it can be said that the impact on the Indian economy of the economic policies of the U.S. Trump administration will be small, but caution is needed to the development of the visa policies to the specialty workers.

7. Widening Income Gaps in India

It is often pointed out that the high growth in the Indian economy has not necessarily contributed to the elimination of poverty or improvement of earnings of the low income earners. This aspect will need a special attention as a risk factor that might threaten the robust economic performance.

South Asia is a region, along with Sub-Sahara Africa, that has a high percentage of poverty group and India is outstanding among them. Specifically noteworthy is the fact that its poverty ratio is higher than in Bangladesh, Pakistan and Nepal despite India has a larger GDP per capita than these three countries. It suggests that the economic development has a smaller contribution to the elimination of poverty. (Chart 9)

Chart 9 : Income level and Poverty Ratio in South Asia

	Per Capita GDP as of 2015,USD	Poverty ratio	
		%	Reference Year
South Asia	1,538.45	15.1	2013
India	1,593.26	21.2	2011
Bangladesh	1,211.70	18.5	2010
Nepal	743.32	15.0	2010
Pakistan	1,434.70	6.1	2013
Sri Lanka	3,926.17	< 2.0	2012

(Note) Poverty ratio refers to the percentage of the people living with less than $1.9 (PPP) a day in the total population。

(Source) "World Development Indicators", World Bank

According to Prof. Amartya Sen, a hallmark economist of India, and others, economic growth has a very limited influence on the social welfare, and the increase of wage and income of most workers other than high-skilled workers is very slow[5]. They advocate the importance of the development of such public services as school education, healthcare, and supply of safe water for the welfare improvement in the developing countries.

Conclusion

In India, structural reforms have been steadily implemented under the Modi administration, including the measures for improvement of infrastructure and simplification of taxation system that are aimed at attracting foreign investment. With these efforts, the economy is considered to keep its robust pace in the foreseeable future. On the other hand, there are risk factors such as (i) a rise of Non-Performing Assets problems, (ii) acceleration of inflation due to a re-bump of oil prices and expansion in the current account deficit, (iii) retarded elimination of income gaps.

As for the NPAs, the possibility that the resolution process will be delayed is low as the injection of public money constitutes only a smaller portion of the economy since the share of the banking sector is still small. The central bank under the control of new Governor Patel that should play an important role in the resolution of the NPAs is expected to follow the policy stance taken by the previous governor Rajan. Taking this into consideration, the possibility will be small that the NPA problem of the banking sector will lead to a serious credit squeeze.

What requires more caution will be the possibility that the oil prices will show a prominent sign of appreciation in the international commodity market after the end of lower oil prices which contributed thus far to the robust performance of the economy together with the progress of the structural reforms and the possibility for a delay in the alleviation of income gaps.

Oil prices have stabilized at low level for the past two years, exerting favorable impacts on

5 Jean Drèze & Amartya Sen (2013) An Uncertain Glory: India and its Contradictions, Princeton University Press

the Indian economy through stable prices and narrowing current account deficits. If they begin to rise substantially, the economy is expected to slow down both through the rise of prices and expansion of current account deficits, threatening to make the policy management difficult by increasing public dissatisfaction. Yet, despite the continued coordinated curtailment of oil production of the OPEC countries, the current supply and demand for the crude oil shows no sign of reduction of oversupply, due to the increased production of shale oil in the U.S. Given the consensus forecast for a price development at around $50 per barrel continuing toward the end of 2017, the oil prices are expected to go through at a low level, and there will be no need to estimate the risks highly.

On the other hand, the alleviation of income gaps seems to be going very slowly. The proceeding structural reforms of the Modi administration have improved the business environment to domestic companies including foreign affiliates, contributing to the economic growth and development of India. However, unless the benefits of robust economy are disseminated to every corner of the society rather than they go to a limited number of entities, poverty will not be eliminated and income gaps will expand. And if the income gaps exceed a certain boundary, the society will be divided with the emergence of egocentrism, heightening the possibility for various social collisions among individuals and corporates and other entities. If they happen to become real conflicts, they will have an adverse effect on the economy. In order to prevent them from become visible, it is important to implement economic policies to promote growth and at the same time to introduce income redistribution policies to take care of the low income group who are left behind by the economic growth. Active discussions for such income redistribution policies are much expected.

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