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Economics Group

Special Commentary

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Indian Economy: Still Deteriorating at the Margin

Executive Summary

Our last report on India was titled "Indian Economy: Some Deterioration at the Margin," and many of the themes that we highlighted then remain in force six months later.[1] Specifically, inflation has remained elevated despite further deceleration in economic activity, and the composition of capital inflows, which are needed to finance the current account deficit, remain skewed toward portfolio investment. Consequently, capital inflows have weakened in the past few months as investors have turned risk averse, causing the Indian rupee to fall to an all-time low against the U.S. dollar.

The service sector has accounted for essentially all the growth in the Indian economy over the past year, and this bias toward services may be playing a role in keeping India's inflation rate elevated. For the country to realize its full potential, the goods-producing sector will need to play a larger role in the Indian economy than it does at present. There probably are a number of factors that are holding back the goods-producing sector, including poor infrastructure. The government is pouring resources into infrastructure, but it will be years before a marked improvement will be made.

Indian GDP Has Decelerated Further

Recently released data show that real GDP in India grew 6.9 percent in the third quarter of 2011, the slowest year-over-year rate of growth since Q2 2009 when the global recession was still under way (Figure 1). Whereas the downtown in the global economy played a very important role in the sharp economic slowdown that occurred in India during 2008–09, real GDP growth in Indian appears to have remained relatively immune, at least thus far, to global factors during the current slowdown. Specifically, exports of real goods and services were up more than 25 percent in the third quarter, little changed from the robust year-over-year growth rates that prevailed earlier this year. Weakness in domestic demand growth, which may reflect the effects of previous monetary tightening, appears to be driving the current slowdown in India.

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Consumer spending, which accounts for nearly 60 percent of Indian GDP, has decelerated recently as the year-over-year growth rate in real personal consumption expenditures slowed from more than 5 percent at the end of 2010 to 3.5 percent in the third quarter of 2011. Timely data on overall retail spending are not readily available, but the behavior of new vehicle registrations recently portray an interesting trend. Registrations fell 9 percent in the third quarter relative to the same period in 2010 (Figure 2). As we discuss in more detail later, interest rates have risen sharply in India this year, and higher borrowing costs may have put a damper on auto sales. Speaking of interest rate-sensitive spending, gross fixed capital formation fell 0.6 percent in the third quarter, the first year-over-year decline in capital expenditures since early 2009.

[1] **This report is posted at www.wellsfargo.com/economics or is available on request.**

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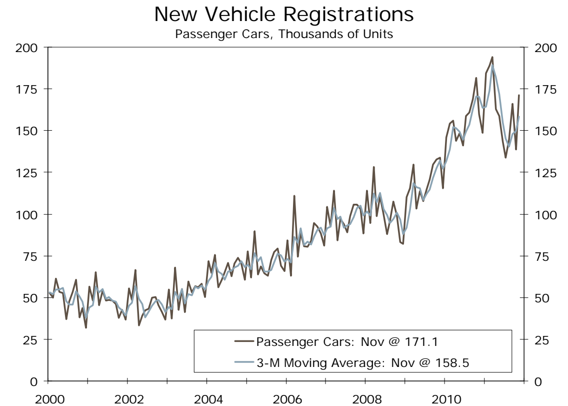
This report is available on wellsfargo.com/economics and on Bloomberg WFEC.

Figure 1

Figure 2



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

Recent weakness in global economic activity does not bode well for Indian export growth in the months ahead.

As noted earlier, real export growth has remained very robust this year. A decomposition of real exports into its underlying components of goods and services is not readily available, but data on nominal values show that growth in goods exports was very strong, at least through the third quarter (Figure 3). However, growth in Indian exports slowed sharply in October, and recent weakness in global economic activity does not bode well for Indian export growth in the months ahead. About 20 percent of India's exports are destined for the European Union, and the incipient recession in the Eurozone will undoubtedly be felt by Indian exporters. Another 20 percent go to other Asian economies, where overall rates of economic growth have slowed in recent months. Service exporters (e.g., business process outsourcing, call centers, etc.) may not be as adversely affected by slower foreign growth as are manufacturers, but the most recent global downturn showed that the former are not totally immune to global economic conditions.[2] Therefore, service exports likely will decelerate as well in coming months.

Figure 3

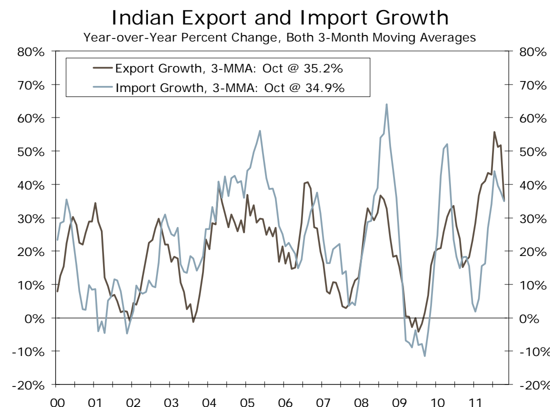
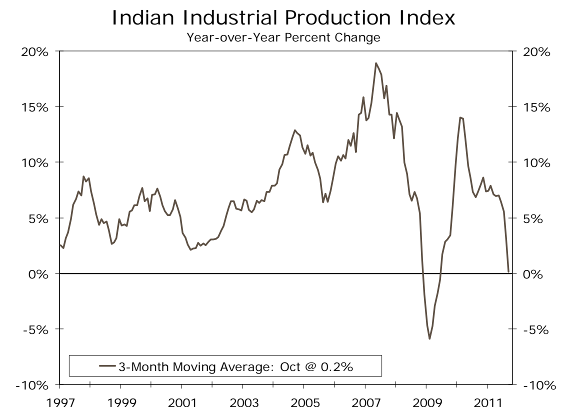


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

The few data points that we have from the fourth quarter suggest that the Indian economy continues to expand, albeit at a moderate pace. Industrial production (IP) fell 5.1 percent on a

[2] The value of Indian goods exports tumbled 15 percent between 2008 and 2009. Although not nearly as severe, exports of Indian "computer and information" services fell 5 percent during that period.

year-over-year basis in October, the weakest IP outturn since early 2009 (Figure 4).[3] In November, the purchasing managers' index (PMI) for the manufacturing sector remained above the demarcation line separating expansion from contraction, but only barely at a reading of 51.0. More encouraging, the service sector PMI printed at 53.2 in November. However, this index was consistently between 55 and 60 earlier in the year. For the fiscal year that ends on March 31, 2012, real GDP in India is projected to grow a bit above 7 percent, down from 8.3 percent last year.[4] We forecast that the Indian economy will grow roughly the same rate in fiscal 2012–13.

Inflation Remains Stubbornly Elevated

Wholesale price inflation has remained stubbornly above 9 percent throughout all of 2011.

Despite the significant slowdown in the Indian economy, inflation has showed few signs of receding, at least thus far. Wholesale price inflation (WPI), which is considered to be the benchmark inflation gauge in India, has remained stubbornly above 9 percent throughout all of 2011 (Figure 5). The sharp increase in food and energy prices that occurred in the second half of 2009 and early 2010 contributed to the initial acceleration in wholesale prices. However, raw food prices have declined in recent months and energy prices have stabilized, but the overall rate of WPI remains elevated. This failure of WPI to recede despite declining food prices and the stabilization of energy prices suggest that the long-run potential growth rate of the Indian economy may not be quite as strong as some analysts believe.[5]

Figure 5

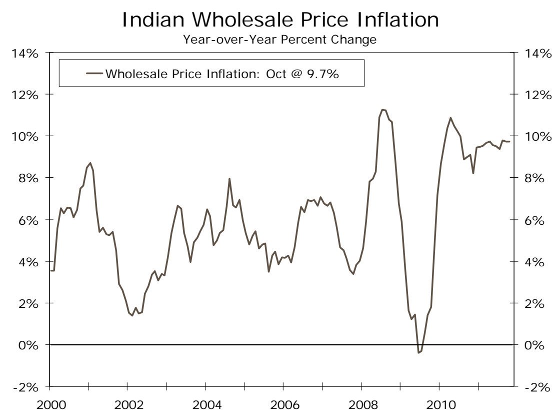
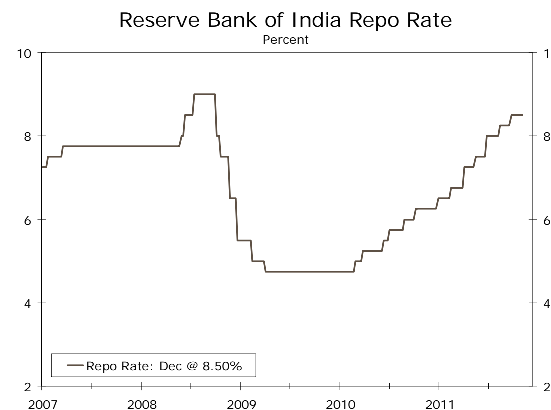


Figure 6



Source: IHS Global Insight and Wells Fargo Securities, LLC

The RBI is probably finished tightening policy.

In response to rising inflationary pressures over the past two years, the Reserve Bank of India (RBI) has tightened monetary policy. Between March 2010 and October 2011, the RBI raised its benchmark policy rate by 475 bps (Figure 6). As noted earlier, it appears that monetary tightening has contributed to the slowdown in the rate of GDP growth this year. The year-over-year GDP growth rate in India is now below 7 percent, and there are many downside risks to global economic growth. Therefore, the RBI is probably finished tightening policy. That said, it is difficult to envision aggressive easing as long as inflation remains at current rates. And as we discuss in more detail later, the recent depreciation of the Indian rupee may reduce the speed by

[3] **Base effects may have exaggerated the year-over-year decline in Indian IP in October. That is, IP surged in October 2010, making for a difficult year-over-year comparison this October. That said, the trend decline in the manufacturing PMI since early in the year suggests that sequential increases in Indian IP have been weakening.**

[4] **Unlike most countries, India uses fiscal rather than calendar years to measure GDP growth. For our macroeconomic forecasts see our *Monthly Economic Outlook*, which is posted at www.wellsfargo.com/economics.**

[5] **Formal estimates of India's long-run potential rate of economic growth are not readily available. However, the consensus forecast looks for Indian real GDP to grow between 8 percent and 8.5 percent per annum between 2013 and 2021, which may be used as a rough estimate of the country's long-run growth potential.**

which WPI recedes in coming months by raising import prices. Therefore, the RBI could remain on hold for the foreseeable future.

Indian Rupee Plumbs All-Time Lows versus the Greenback

One normally associates rising interest rates with currency appreciation, and the Indian rupee had strengthened versus the U.S. dollar in the first half of 2011 as the RBI continued to tighten policy (Figure 7). However, the rupee has completely fallen out of bed over the past few months, and it recently dropped to an all-time low against the greenback. What is wrong with the Indian rupee?

Portfolio investment accounts for two-thirds of capital inflows.

India incurs a modest current account deficit, which means that the country must finance this red ink with net capital inflows.[6] Unfortunately, the composition of these inflows makes the rupee susceptible to bouts of depreciation when investors turn risk averse. Specifically, portfolio investment accounts for two-thirds of capital inflows (Figure 8). Because many securities can be liquidated relatively easily, investors can sell Indian assets in favor of "safe-haven" assets, such as U.S. Treasury securities, when risk aversion rises as it has over the past few months as the European sovereign debt crisis has entered a more acute phase. Indeed, net foreign purchases of Indian securities turned sharply negative starting in August.[7]

Figure 7

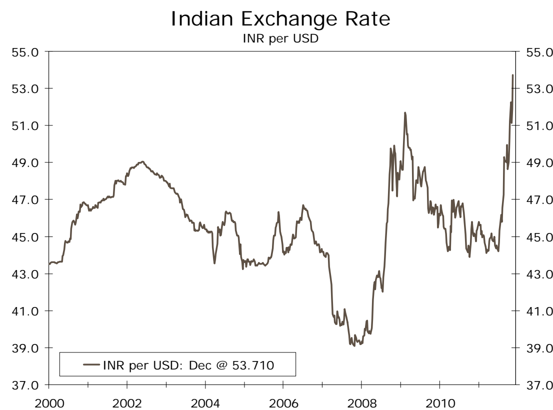
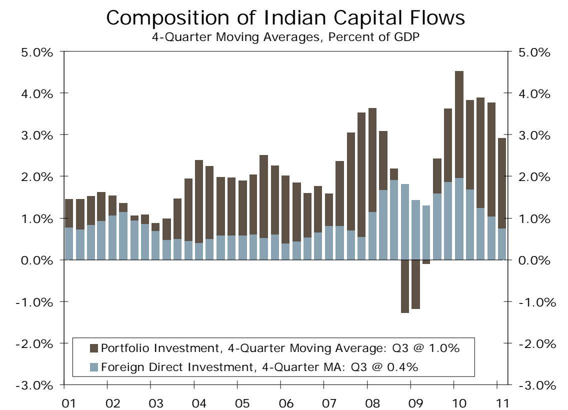


Figure 8



Source: IHS Global Insight, CEIC and Wells Fargo Securities, LLC

In contrast, the amount of foreign direct investment (FDI), which is a more stable form of capital inflows, is relatively modest in India. In 2010, FDI in India totaled $32 billion, which sounds like an impressive amount until it is compared to the $200 billion that poured into China last year. Not only does the relatively modest amount of FDI have currency implications for India, but as we discuss in the next section, it also has ramifications for long-term economic growth prospects.

Are Services Compatible with Strong Long-Run Economic Growth?

There probably are a number of reasons for the relatively low amount of FDI in India, including the inefficient government bureaucracy, corruption and restrictive labor market regulations. However, the poor state of Indian infrastructure appears to be an important factor that reduces the incentive for foreigners to invest directly in India. Indeed, many businesses rank inadequate

[6] Over the past four quarters, India has incurred a current account deficit of roughly $45 billion, which is equivalent to nearly 3 percent of Indian GDP. A sizable trade deficit in goods, which totaled 12 percent of GDP, was partially offset by a modest surplus in trade in services. In addition, Indians who work abroad send home billions of dollars in remittances every year.

[7] The BSE-500 index, which represents more than 90 percent of the market capitalization of the Indian stock market, has dropped nearly 30 percent this year. About two-thirds of that decline has occurred since the end of July.

infrastructure as the most problematic factor for doing business in India.[8] Poor infrastructure probably has more negative implications for goods producers than it does for service providers. Goods producers need quality roads, railways and ports to facilitate movement of their inputs and output. And the health of a country's goods-producing sector can have important implications for its long-run growth prospects.

The service sector has accounted for essentially all of the growth in Indian value added over the past four quarters.

As discussed in our last report on India in June, the goods-producing sector in India remains small, at least relative to China.[9] Specifically, the goods-producing sector accounts for less than 30 percent of value added in the Indian economy, whereas the comparable figure in China is nearly 50 percent (Figure 9). Moreover, the service sector has accounted for essentially all of the growth in Indian value added over the past four quarters (Figure 10).[10] As we argued in our previous report, productivity growth in the goods-producing industries, especially manufacturing, tends to be stronger than in either the agricultural or service sectors. Strong growth in the service sector at the expense of the goods-producing sectors may be retarding overall productivity growth in the Indian economy and contributing to the evident inflation problem the country faces.

Figure 9

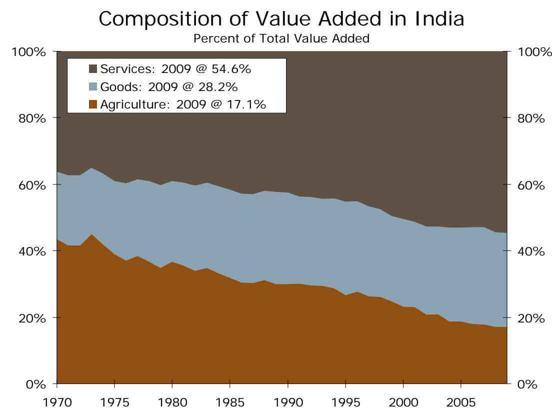
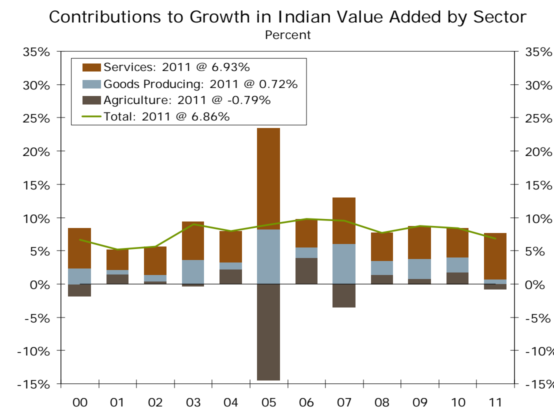


Figure 10



Source: United Nations, CEIC and Wells Fargo Securities, LLC

Relatively low amounts of FDI may help to hold back growth in the Indian goods-producing sector.

The government recognizes the infrastructure shortfall that the country faces and is earmarking resources to address the problem. Spending on railways in the 2008–2010 period, the first three years of the current five-year plan, is up about 80 percent relative to the same period in the previous five-year plan. Spending in the electricity, gas and water sector has risen by a similar amount. However, it takes years, if not decades, to make a significant change in the overall infrastructure profile for a country as large as India. Until the quality of Indian infrastructure improves significantly, the amount of FDI entering India, which usually brings with it important technology transfer, will probably remain limited, at least relative to Chinese standards. Everything else equal, relatively low amounts of FDI may help to hold back growth in the Indian goods-producing sector.

[8] Roughly 25 percent of respondents identified "inadequate supply of infrastructure" as among the top five "most problematic factors for doing business" in India. Inadequate infrastructure was followed by the "inefficient government bureaucracy" (14 percent), corruption (11 percent) and "restrictive labor regulations" (11 percent) as the next most problematic factors. See *The Global Competitiveness Report, 2009-2010*, which is published by the World Economic Forum.

[9] The goods-producing sector includes mining, manufacturing, manufacturing and construction.

[10] On a year-over-year basis, overall value added rose 6.9 percent in the third quarter. Value added in the service sector was up 6.9 percent, and the 0.7 percent increase in the goods-producing sector was offset by the 0.8 percent decline in the agricultural sector. The annual increase in value added in the goods-producing sector has not been this weak since 2001.

Conclusion

Six months ago, we wrote that macroeconomic fundamentals in India were deteriorating at the margin, and many of the themes that we highlighted then are still relevant today. Inflation remains elevated despite the slowdown in economic growth that has occurred over the course of the year. The country continues to incur a modest current account deficit that it finances largely with inflows of portfolio investment. In the current environment of heightened risk aversion that is due, at least in part, to the ongoing concerns about the sovereign debt situation in Europe, foreign investors have unloaded some of their holdings of Indian securities. The foreign exodus from Indian assets has caused the Indian rupee to fall to an all-time low versus the greenback.

Unless Europe "blows up," a replay of 2008–2009, during which Indian GDP growth slowed sharply, does not appear likely. We forecast that Indian real GDP will grow between 7 percent and 8 percent per annum over the next two years. These growth rates obviously are quite high relative to the standards of most other countries, but they also are not quite as extraordinary as the 9 percent rates that India achieved during the 2006–2007 boom. Inflation should also recede somewhat over the course of 2012.

In order to fully achieve its long-run potential, manufacturing will need to play a bigger role in the Indian economy than it does at present. One of the factors that have helped to hold back the manufacturing sector has been the poor state of Indian infrastructure. The government is cognizant of the infrastructure problem, and it is devoting more resources to address the issue. However, it will be years before India has first-rate infrastructure, which may restrain growth in the goods-producing sector and ultimately growth in the overall economy.

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