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In a nutshell

► India’s economic growth continued to be robust in the past few years despite an increase in the volatility of the global economy. In the three years ended March 2011, the GDP growth has averaged 7.8% per annum (p.a.), moderately lower than the 9.5% p.a. expansion recorded in the prior three years. Consumption has played a critical role in sustaining India’s growth momentum, clocking an average 8.3% p.a. expansion in the three years ended March 2011. Investment however has subsided, expanding by an average 5.8% p.a. in the past three fiscal years following higher risk aversion among investors due to the global financial crisis in 2009.

► In the wake of the recent European debt crisis, India's GDP growth momentum has waned evidenced by its performance in the 3Q2011 when it moderated to 6.9% on a year-on-year basis. Recent high frequency data are also indicating higher risks to a slowdown in India's GDP growth. For instance, the growth rate of money supply as measured by M1 has declined sharply since the last quarter of 2010. Notwithstanding this, we do not foresee India’s GDP growth to decelerate to below 6.5% in the near term as overall growth trajectory is well supported by strength in the consumer sector, where personal disposable income has grown an average of 14.7% from FY2006-2010. As such, we concur with the forecast by the International Monetary Fund (IMF) on India's long-term growth trajectory of circa 7.5% to 8.5%.

► With sustained strong economic growth in the past several years, inflationary pressure in India has continued to build up, as shown by its wholesale price index (WPI) - India's major inflation indicator - which climbed 9.6% in FY2010 from just 3.9% in FY2009. The trend in the WPI was also explained by the price of oil imports, India’s major import component. Although the source of upward price pressure initially originated from negative supply factors, a swift recovery in economic activity post the Great Recession also led to the emergence of demand-pull factors. In fact, recent high frequency data suggests that demand-led factors had become an important source of high prices by 2011.

► High prices of food have also become a major concern in recent years evidenced by the food component index which escalated by double-digit rates of 12.7% and 17.7% respectively in 2009 and 2010 before moderating in the 4Q2011. High food prices were largely the result of unfavourable weather factors, growing demand for high-protein diets from an increasingly affluent population, and persistent supply bottlenecks due to the country's inefficient distribution system.

► India’s current account balance has been in the red for many years following persistent deficits in the trade balance. Massive deficits in the goods account were responsible for the overall negative balance in the current account although persistent surpluses have been recorded in the services portion of the current account. India’s current account deficits had surged to US$38.2 billion in 2010 from just an US$9.6 billion deficit in 2007. In terms of its percentage of GDP, India's current account deficit had reached 2.7% in the FY2009-10, compared with 1.0% in the FY 2006-07.

► The budget deficit is a thorny issue for India as it has persisted for at least the last four decades. As a ratio to GDP, India's budget deficit hit a peak of 6.4% in FY2009-10 after economic growth slowed to 6.8% during the Great Recession. Prior to that, India was making a consistent effort to trim its budget deficit from 4.0% of GDP in the FY2005-06 to 2.5% in the FY2007-08 following a strong pick up in revenue growth. However, with economic growth accelerated rapidly in recent years, total expenditure also increased dramatically, expanding by an average 19.2% p.a. between 2006-2010 from an average 9.3% p.a. between 2001-2005.

► Although budget deficits will continue to cloud India's fiscal position in the medium term, some positive aspects are worth highlighting. This includes amongst others the government’s ability to collect higher taxes in recent years, high long-term growth trajectory in the range of 7.5% and 8.5% in the next five years according to IMF forecasts, and the government’s commitment to keep on reining in deficits in recent years.

► The overall government debt position continued to improve in recent years as nominal GDP expanded at a robust pace. Based on IMF data, the general government gross debt as a percentage of GDP had declined to 64.1% in 2010, compared with 81.7% in 2003. India's external debt position as a percentage of GDP is also improving, dropping from 20.5% in the FY2008-09 to circa 17.4% in FY2010-11 while its debt service ratio improved to 4.2% in the latest FY2010-2011 from 10.1% in the FY2005-06. Notwithstanding this, India's short term debt has increased at a more rapid pace in recent years, while the ratio of short-term debt to total debt increased to 20% in the FY2009-10 from as low as 2.8% in the FY2001-02.

►In the banking sector, total credit growth has been robust as high economic growth fueled strong demand for loans. Since 2008, total credit as a percentage of GDP has surpassed 50% and by 2010, it expanded to roughly 54%. The loan-to-deposit ratio among commercial banks remained relatively stable at circa 72% in the FY2009-10, albeit lower than the 74.5% recorded in the FY2006-07. India's banking system capital adequacy ratio has been on the rise from 12.3% in 2007 to approximately 13.6% in 2010.

► Despite these favourable statistics, slower economic momentum, high inflation and interest rates have affected the banking sector and raised the possibility of higher defaults among borrowers. Recent statistics indicate that the gross non-performing assets (NPA) has risen to 2.8% in September 2011 from 2.3% in March 2011. Similarly, the net NPA ratio rose from 0.9% to 1.2% within the same period. Apart from asset quality, banks' capitalisation has also been adversely affected, evidenced by the decline in the capital to risk weighted assets ratio (CRAR) to 13.5% in September 2011 from 14.5% and 14.2% in March 2010 and March 2011 respectively.

► Massive capital outflows and excessive weakening of the Indian Rupee (INR) have become the major concerns in the 2H2011 as foreign investors exited India following signs of increasing trouble in India's economy. Portfolio investments shrank by US$1.6 billion in 3Q2011 compared with a US$2.5 billion increment in the preceding quarter. Similarly, equity and investment fund shares contracted by US$1.7 billion in the 3Q2011 after rising by an average US$7.6 billion per quarter in 2010 while debt securities investment dropped to US$0.13 billion from an average US$1.9 billion per quarter within the similar period. Long term inflows of direct investment also languished in recent years after reaching a peak of US$43 billion in 2008.

► A comparison of critical marcoeconomic matrices among selected Asian countries reveal that India's position is favourable in a number of dimensions. A positive feature of the economy is the international reserve position which benefited from high export growth. India's 5-year median reserve-to-import ratio of about 11 months is among the highest in the Asian region, providing cover for the trade deficit and insurance against sharp capital outflows. In another positive development, India's strong economic growth in the past two decades has led to a rapid increase in per capita income although its level is lower than the region's 5-year average of its median.

► On the negative side, the government fiscal position versus current account balance matrix remains relatively unfavourable with the budget gap being among the largest when compared with the region's 5-year average of its median. In addition, the current account balance has been persistently in deficit as oil imports continued to rise in recent years. The economy is also characterised by higher inflation when compared with other regional economies as the upward pressure on prices are driven by both demand and supply factors. In a matrix that combines the government debt versus fiscal balance, India is in the least favourable quadrant, with relatively high government debt and large budget deficits. Notwithstanding this, a persistent downtrend in the debt position and a continuous effort to reduce budget deficits will likely move India to a more favourable quadrant in the medium term. Comparing the fiscal balance against tax revenue, India is again in the least favourable quadrant as tax collection is relatively low against a persistent budget deficit. Nevertheless, future prospects on this score look bright judging by the persistent improvement in the ratio of taxes to total revenue and strong GDP growth trajectory in the past several years.

Introduction

India is one of the world's most populous nations with a total population of 1.2 billion as of 2010, second only after China (1.3 billion). Since the early 1990s, the country has been rapidly embracing an open-market economy after adhering to a socialist policy after its independence in 1947. Among major economic liberalisation measures introduced were industrial deregulation, privatisation of state-owned enterprises and reduction in controls on foreign trade and investment. Since then, the economy has registered an average GDP growth of 7.0% p.a. during the new millennium compared with 5.5% p.a. in 1990s and 4.6% p.a. in 1980s. More than half of India's workforce is in the agricultural sector but the services industry is gaining a foothold, commanding 25.2% of total employment in 2005 (2000: 24.1%). Despite strong economic growth in recent years, the country is still grappling with a high incidence of poverty evidenced by a massive 51.4% of the employed workers living on less than US$1.25 a day between 2000 and 2008, according to the data provided by the United Nations (UN). Hence, the government is focusing on efforts to improve physical and social infrastructure, accessibility to basic necessities and higher education in order to promote sustainable and inclusive growth.

Growth Performance and Prospects

India's economic growth continued to be robust in the past few years despite an increase in the volatility of the global economy. In the three years ended March 2011, the GDP growth has averaged 7.8% p.a., moderately lower than the 9.5% p.a. recorded in the prior three years. Even during the Great Recession in 2009, India's GDP growth was sustained at 6.8% which was among the fastest in the world.

Consumption has played a critical role in sustaining the growth momentum in India, clocking an average 8.3% p.a. in the three years ended March 2011. Private consumption was also robust, expanding at an average rate of 7.9% p.a. during the same period. Even during the global economic turmoil in 2009, private consumption had grown at a blistering pace of 7.7% as consumers responded favourably to interest rates cuts implemented by the Reserve Bank of India (RBI). Investment however has subsided, expanding by an average 5.8% p.a. in the past three fiscal years, compared with an average expansion of 15.4% p.a. between 2005-2008 following higher risk aversion among investors due to the global financial crisis in 2009.

On the supply side, the manufacturing sector continued to become an important source of growth, expanding by an average 7.1% p.a. in the three years between 2008-2010. The sector had been mildly affected during the Great Recession, moderating to 4.2%. Notwithstanding the importance of the manufacturing sector, the increasing role of the services sector was also reflected in its share to GDP which climbed to roughly 60% in 2010 from 48% in 1995. The growth of the services sector had also been commendable, averaging 9.7% p.a. between 2008-2010, albeit slower than the 10.4% p.a. recorded in the prior three years.

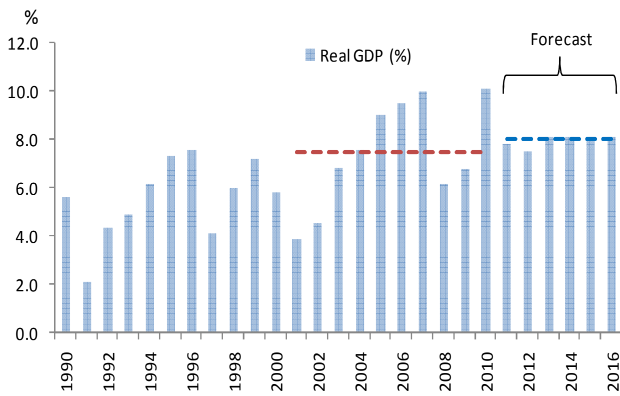
In the wake of the European debt crisis in recent times, India's GDP growth momentum has waned evidenced by its performance in the 3Q2011 when it moderated to 6.9% on a year-on-year basis (2Q: 7.7%). The slower growth came on the back of a moderation in private consumption which registered a milder 5.9% expansion compared with 6.3% growth recorded in the 2Q2011. More critically, investment contracted by 0.6% compared to a robust 7.9% expansion in the preceding quarter.

Recent high frequency data are also indicating higher risks to a slowdown in India's GDP growth. For instance, the growth rate of money supply as measured by M1 has declined sharply since the last quarter of 2010. The year-on-year growth rate has fallen to merely 1.5% in November 2011 from a robust 21.1% expansion in November 2010 before rebounding to 6.1% in December 2011. Similarly, the growth rate of currency held by the public also slumped to 12.1% in November from 20.5% a year ago while the growth rate of demand deposits also shrank to 10.5% in November 2011. The potential cash crunch in the banking system and the threat to growth has prompted the RBI to reverse course and begin easing monetary policy, with the Cash Reserve Ratio (CRR) cut from 6.0% to 5.5% and sparking speculation over future interest rate cuts.

Going forward, economic growth prospects are clouded by the repercussions from the European debt crisis as well as the lagged effect from aggressive monetary tightening measures implemented by the RBI in the past one year. On a sectoral basis, the growth rate in the agriculture sector is expected to somewhat normalise in the next one year or so after a minuscule growth of 0.4% recorded in the FY2009-10 from 5.1% in the FY2006 due to more favourable weather factor (our assumption). On the other hand, the manufacturing sector will likely bear the brunt of slower demand from abroad as well as the lagged effect from the policy tightening policy in the past one year. As such we foresee the expansion in the manufacturing sector to be below 8%, compared with the average 8.6% p.a. registered in the FY2009-11.

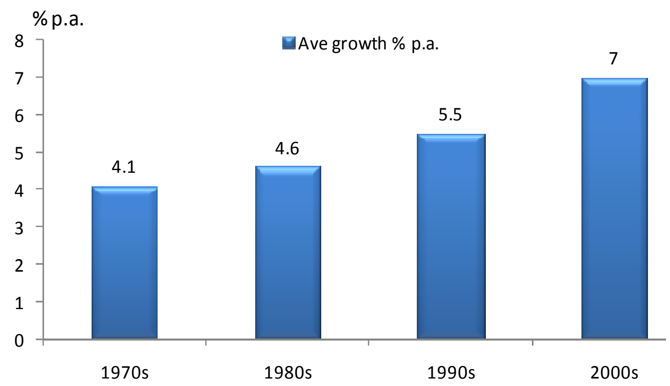
Notwithstanding this however, we do not foresee India's GDP growth to decelerate to below 6.5% in the near term. The experience during the Great Recession suggests that the overall growth trajectory is well supported by strength in the consumer sector, where personal disposable income has grown an average of 14.7% from FY2006-2010. As such, we concur with the forecast by the IMF on India's long-term growth trajectory of circa 7.5% to 8.5% as consumer spending continues to fuel the economy while the relatively high investment ratio sustains the growth momentum in the next several years.

Chart 1: GDP growth (%) – past and projected



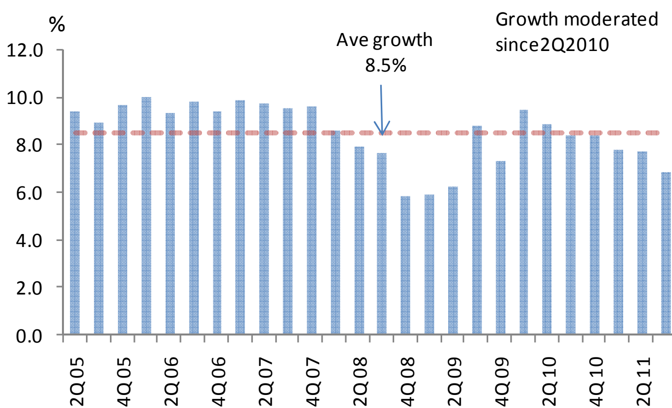
Source: IMF

Chart 2: Ave GDP growth p.a. % in 1970s, 80s, 90s and 00s



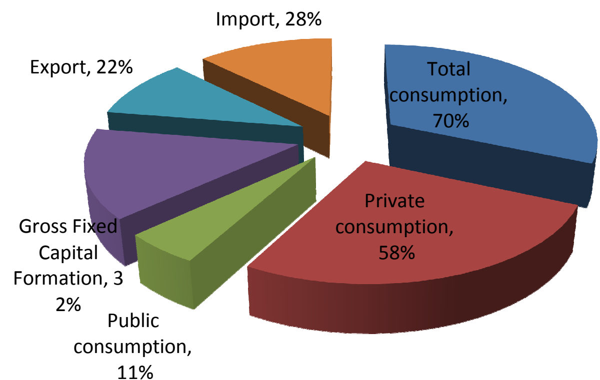
Sources: CEIC, MARC Economic Research

Chart 3: GDP growth (%) – recent quarters



Source: CEIC

Chart 4: Structure of the economy

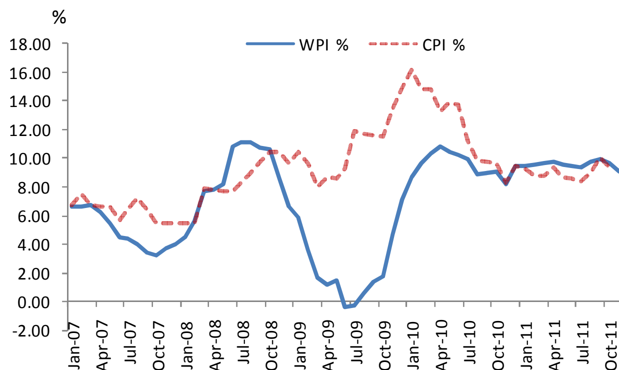


Source: CEIC

Inflation

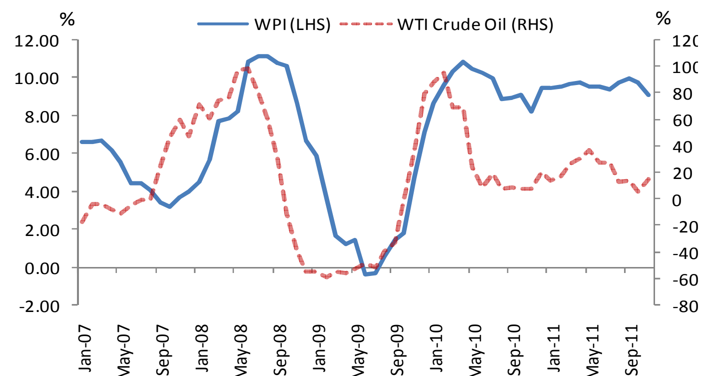
With sustained strong economic growth in the past several years, inflationary pressure in India has continued to build up, as shown by its WPI - India's major inflation indicator - which climbed 9.6% in FY2010-11 from just 3.9% in FY2009-10. The trend in the WPI was also explained by the price of oil imports, India's major import component. High oil prices normally lead to rising WPI which in turn, cause the overall consumer prices to rise.

Chart 5: Wholesale price index (WPI) and consumer price index (CPI) (yoy %)



Source: CEIC

Chart 6: WPI and WTI crude prices growth (yoy %)



Sources: CEIC

Table 1: Average prices – CPI, WPI and food (%)

	CPI	Food Price index	WPI
1996-2000	7.3	6.2	5.1
2001-2005	4.1	3.1	4.7
2006-2010	9.2	11.1	6.2

Source: RBI, ADB
**Some statistics for 2001-2005 were re-adjusted due to missing data*

Although the source of upward price pressures initially originated from negative supply factors, a swift recovery in economic activity post the Great Recession also led to the emergence of demand-pull factors. In fact, recent high frequency data suggests that demand-pull factors have become an important source of high prices by 2011.

In November 2011, the RBI Governor highlighted the problem of rising wages particularly for urbanites which partly explained the rising inflation in the 2H of the new millennium. Accordingly, between 2005 and 2010, wages had risen by 10.5% compared with the 3.6% increase recorded between 2000 and 2005.

High prices of food have also become a major concern in recent years evidenced by the food component index which escalated by double-digit rates of 12.7% and 17.7% in 2009 and 2010 respectively before moderated to single digits in the 4Q2011. High food prices were largely the result of unfavourable weather factors, growing demand for high-protein diets from an increasingly affluent population, and persistent supply bottlenecks due to the country's inefficient distribution system.

Consumer prices as measured by the consumer price index (CPI) also followed the same trend, rising dramatically since 2007 and averaging 12.3% in FY2009-10 compared with 6.2% in the FY2007-08. By the end of 2011 however, inflationary pressure has started to ease following a moderation in economic

growth and more importantly, the lagged effect of the aggressive monetary tightening by the RBI. In the final week of December 2011, food inflation fell sharply to 0.42% year-on-year following an improvement in the supply factors although the CPI remained above 9% in the whole of November.

External Sector

India's nominal exports have grown at a robust pace, averaging 21.2% p.a. between FY2005-2010, up from an average 10.7% p.a. between FY1996-2000. Since 2008, the United Arab Emirates has become India's major export destination, accounting for roughly 13% of total exports, surpassing the United States which previously was the major export market. During the Great Recession in 2009, real exports contracted by 5.5% compared with a 14.4% growth in the preceding year. Following a brief global recovery, real exports rebounded strongly in 2010, expanding by close to 18%.

Import growth has also remained strong. In INR terms nominal imports continued to climb in the 2H2011, registering an average growth rate of 34% between July and November, compared with an average 23.6% in the 1H2011 and 18.1% in the 2H2010. Part of the reason for the strong increase in imports was the steady rise in oil prices, India's major import component.

As imports continued to outpace imports, the trade balance has continued to remain in deficit, recording a monthly surplus just 11 times in the past twenty years. The trade deficit which recorded a cyclical low in February 2009 during the height of the Great Recession had more than quadrupled by November 2011 as imports of petroleum crude and products surged by 202% within that period.

India’s current account balance has been in the red for many years following persistent deficits in the trade balance. Based on IMF data, India's current account of the balance of payments has registered negative balances in all but four of the last 30 years. Massive deficits in the goods account were responsible for the overall negative balance in the current account although persistent surpluses had been recorded in the services segment of the current account. One of the primary concerns relating to India’s external sector is the exponential increase in current account deficits which had reached US$38.2 billion in 2010 from just an US$9.6 billion deficit in 2007. In terms of its percentage of GDP, India's current account deficit had reached 2.7% in the FY2009-10, compared with 1.0% in the FY 2006-07.

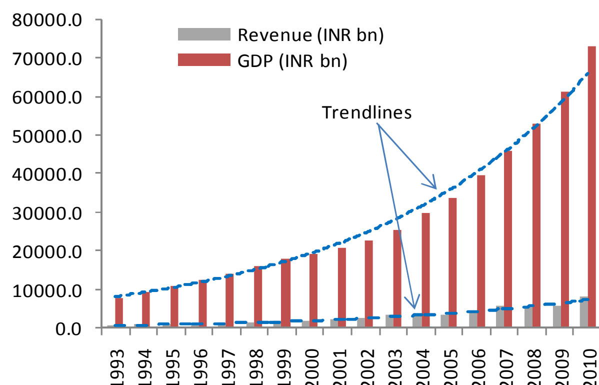
Going forward, exports will likely grow in high single digit pace in the 1H2012 before accelerating to above 20% again in the 2H2012 as the impact of the European crisis affects global trade volume in the first six months of 2012. However, as imports are envisaged to remain high, the trade balance will continue to be in deficit, exerting additional pressure on the current account balance and the exchange rate. Based on the current trend, India's current account may register another year in deficit of circa 3.5% of GDP in 2012.

Government Fiscal Position

The budget deficit is a thorny issue for India as it has persisted for at least the last four decades. As a ratio to GDP, India's budget deficit hit a peak of 6.4% in FY2009-10 after economic growth slowed to 6.8% during the Great Recession. Prior to that, India was making a consistent effort to trim its budget deficit from 4.0% of GDP in the FY2005-06 to 2.5% in the FY2007-08 following a strong pick up in revenue growth.

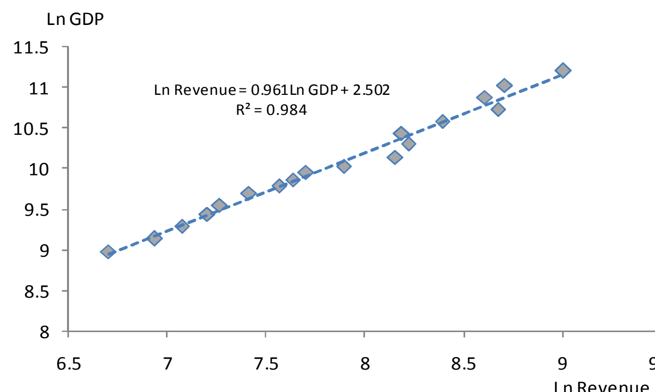
Central government revenue has increased at a faster pace in recent years as economic growth accelerated in the second half of the last decade. However, with economic growth accelerated rapidly in recent years, total expenditure also increased dramatically, expanding by an average 19.2% p.a. between 2006-2010 from an average 9.3% p.a. between 2001-2005. The sharp rise in expenditure was largely attributed to the massive increase in outlays to support investments in order to sustain respectable growth rates for the economy. Due to this rapid surge in government expenditure vis-a-vis its revenue, the government’s fiscal position has remained in the red in the past years.

Chart 7: Total central government revenue and GDP with trendlines (INR bn)



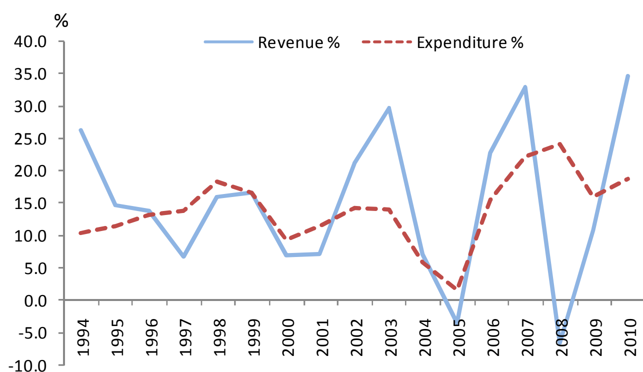
Source: ADB, MARC Economic Research

Chart 8: Close correlation between revenue and GDP (in log terms)



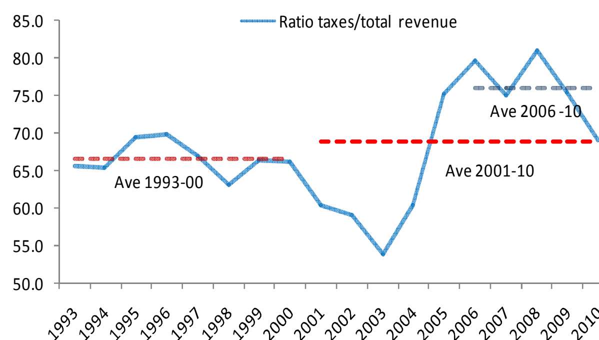
Sources: ADB, MARC Economic research

Chart 9: Growth of central government revenue and expenditure (%)



Source: ADB

Chart 10: Ratio taxes to government revenue

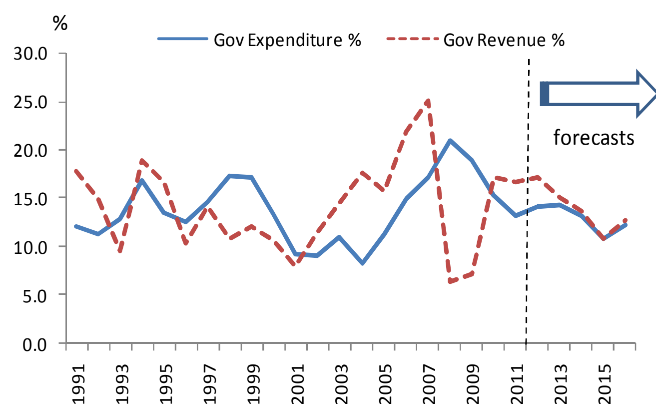


Sources: ADB, MARC Economic Research

Looking from the overall general government perspective (both central and state governments), data from the IMF indicated that total government revenue started to register a double-digit pace expansion starting from 2002 (11.4%) as economic growth accelerated. The growth in general government revenue hit a peak of 25% in 2007 before moderating to single digit rates in 2008 and 2009 following the economic slowdown. Between 2006 and 2010, general government revenue expanded at an average rate of 15.6% p.a., up from an average 13.4% p.a. in the 1H of the new millennium and an average 11.6% p.a. between 1996 and 2000.

Notwithstanding the robust revenue growth, the general government expenditure has also expanded rapidly in recent years as the government pushed for higher investments to keep economic growth at respectable rates. As a result, the general government expenditure climbed by an average 17.4% p.a. between 2006 and 2010 compared with an average 9.7% p.a. between 2001 and 2005.

Chart 11: Growth of general government revenue and expenditure (%)



Source: IMF

Table 2: Growth of general government revenue and expenditure (%)

	General Government	
	Expenditure	Revenue
	%	%
1990-95	13.3	15.6
1996-00	15.0	11.6
2001-05	9.7	13.4
2006-10	17.4	15.6
2011-16	12.9	13.9

Sources: IMF, MARC Economic Research
**denotes forecasts by IMF*

Although budget deficits will continue to cloud India's fiscal position in the medium term, some positive aspects are worth highlighting. This includes amongst others the government's ability to collect higher taxes in recent years, evidenced by the average tax-to-revenue ratio of 76% between 2006-2010, up from an average 67% between 1993-2000 and an average 69% between 2001-2006.

Second, as India's long-term growth trajectory will be in the range of 7.5% and 8.5% in the next five years according to IMF forecasts, revenue growth will likely remain robust as the latter correlates closely with economic performance (99% correlation based on log regression - see chart 8).

Third, although the government has not been successful in bringing the deficits down to the projected levels in recent years, efforts to keep on reining in the deficits have continued. For instance, the government established the Fiscal Responsibility Act 2003 (FRBM), aimed at bringing deficits down by 0.3 percentage points every year. Spending cuts on major subsidies such as food and fertilisers were also implemented in 2010 while the government continued its commitment to lower the deficits during the last 2011-12 Budget.

Government Debt

The overall government debt position continued to improve in recent years as nominal GDP expanded at a robust pace. Based on IMF data, the general government gross debt as a percentage of GDP had declined to 64.1% in 2010, compared with 81.7% in 2003.

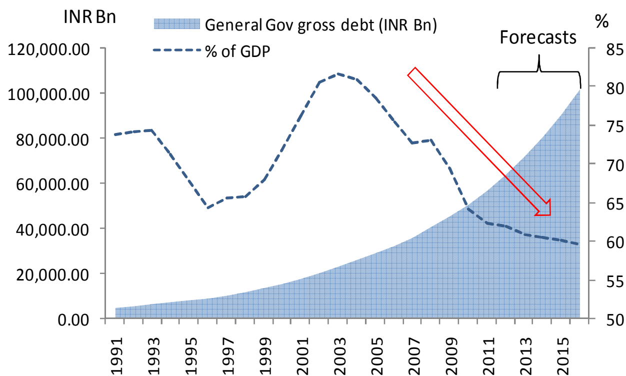
India's external debt position as a percentage of GDP is also improving although its absolute amount had risen to US$306.4 billion in the FY2010-11 from as low as US$98.9 bn in the FY2001-02. In the 10 years ended March 2010, India's absolute amount of external debt climbed at a cumulative average growth rate (CAGR) of 11.1%. The year-on-year increase however has been volatile, ranging from -2.5% p.a. in the FY2001-02 to 30.2% p.a. in FY2007-08 prior to the global financial crisis. As a ratio to GDP however, India's external debt has declined from 20.5% in the FY2008-09 to circa 17.4% in FY2010-11. Its debt service ratio has also improved in the past several years dropping from 10.1% in the FY2005-06 to 4.2% in the latest FY2010-2011, suggesting that the overall external debt situation is improving.

Notwithstanding this however, India's short term debt has increased at a more rapid pace in recent years, rising from a low of US$2.7 bn in FY2001-02 to US$52.5 bn in the FY 2009-10. The ratio of short-term debt to total debt has also increased to 20% in the FY2009-10 from as low as 2.8% in the FY2001-02.

More positively, India has accumulated the world's sixth largest foreign exchange reserves war chest, standing at US$306 billion as at end FY2011. This is sufficient to cover 9.6 months worth of imports; it

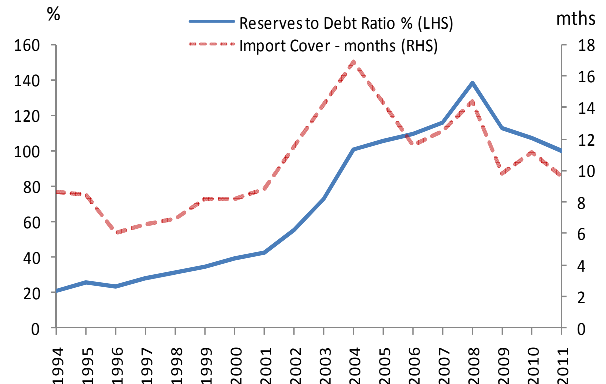
is also virtually at par with the quantum of external debt and five times short term external debt. India therefore possesses sufficient foreign exchange liquidity to withstand considerable outflows of capital while addressing short term debt repayments.

Chart 12: General government gross debt in INR (bn) and % of GDP



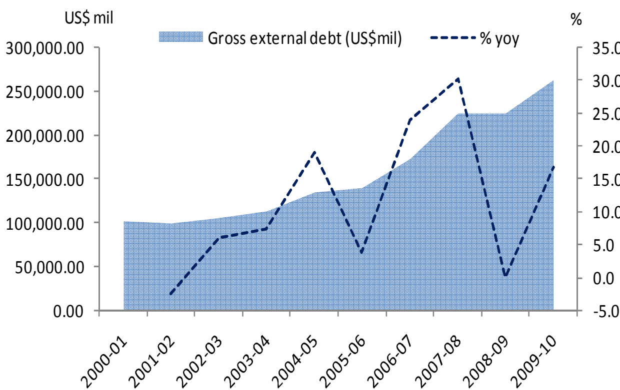
Source: IMF

Chart 13: External reserves to debt ratio and import cover



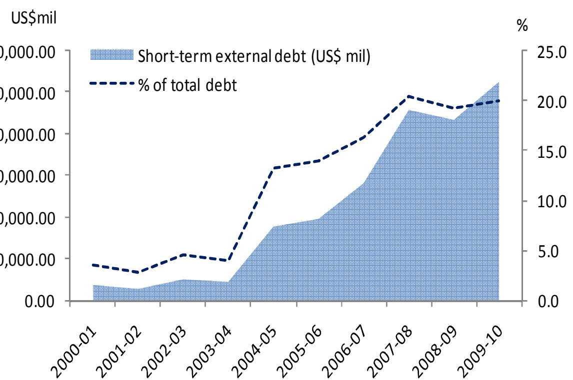
Sources: RBI, CEIC, MARC Economic Research

Chart 14: Gross external debt in US$mil and % change



Source: RBI

Chart 15: Short-term external debt US$mil and as % of total debt



Sources: RBI

Banking and Financial System

Total credit growth has been robust in recent years as high economic growth fueled strong demand for loans. Since 2008, total credit as a percentage of GDP has surpassed 50% and by 2010, it expanded to about 54%. Credit growth among commercial banks has also remained strong, registering a 21.9% expansion in the FY2010-11, although moderating from the 31% recorded in the FY2005-06. According to news flow, outstanding bank loans have also remained resilient in the 12 months to October 2011, expanding by 19% year-on-year compared with 21% growth in the last financial year. The loan-to-deposit ratio among commercial banks remained relatively stable at circa 72% in the FY2009-10, albeit lower than the 74.5% recorded in the FY2006-07. India's banking system capital adequacy ratio has been on the rise from 12.3% in 2007 to 13.6% in 2010.

Despite these favourable statistics, some recent developments are worth noting. Slower economic momentum, high inflation and interest rates have affected the banking sector and raised the possibility of higher defaults among borrowers. For instance, recent statistics indicate that the gross non-

performing assets (NPA) has gone up to 2.8% in September 2011 from 2.3% in March 2011. In the same vein, the net NPA ratio rose to 1.2% from 0.9% within the same period. Among sectors that contributed to the rise in the NPA were priority sector, retail, real estate and infrastructure where their combined shares of total NPA stood at 85% in September 2011. Recent news flow also carried news of higher defaults among banks in India. For instance, the State Bank of India reported an increase in provisions and defaults in the three months to September 30. Accordingly, bad debt has risen to 4.2% in the recent quarter from 3.4% a year earlier.

Apart from asset quality, banks' capitalisation has also been adversely affected, evidenced by the decline in capital to risk weighted assets ratio (CRAR) to 13.5% in September 2011 from 14.5% and 14.2% in March 2010 and March 2011 respectively. The erosion in banks' capitalisation underscores the deterioration in asset quality which resulted in lower profitability among banks.

Table 3: Selected macro-prudential indicators

	2007	2008	2009	2010
Capital adequacy ratio	12.3	13.0	13.2	13.6
Gross NPA (SCB) (%)	2.4	2.4	2.5	2.4
Household debt/GDP (%)	10.0	10.2	8.7	8.2
Loan/Deposit ratio	74.1	73.6	72.4	72.2
Total credit/GDP (%)	46.2	50.1	53.8	53.5

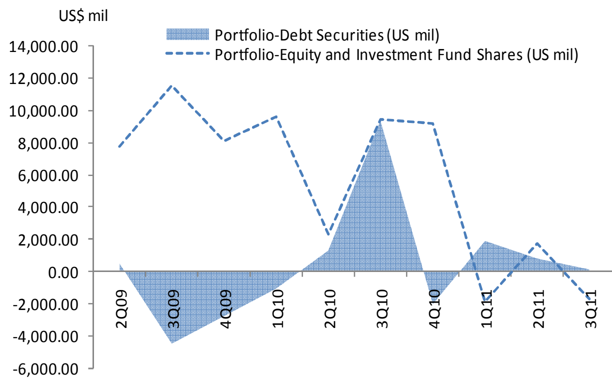
Source: CEIC, RBI, HSBC

Realising the need to maintain order and stability in the financial system, the government has resorted to measures to attract foreign funds into India's market. For instance, in November 2011, the RBI announced that proceeds from external commercial borrowings (ECB) will have to be brought back into the country immediately. Previously, such funds could be temporarily parked in offshore accounts. In addition, since January 2011, the government has decided to allow qualified foreign investors (QFI) to directly invest in the Indian equity market in order to broaden and deepen the capital market. Previously, QFIs were only allowed to invest in mutual funds.

Capital Flows and the Rupee

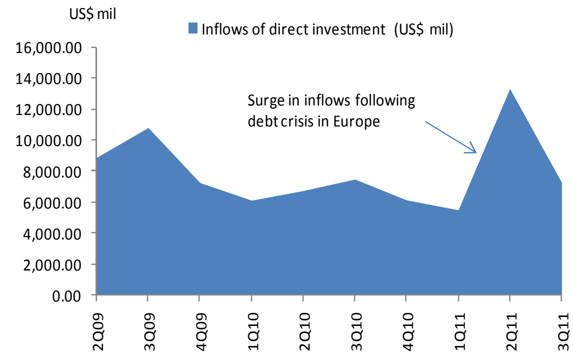
Massive capital outflows and excessive weakening of INR have become major concerns in the 2H2011 as foreign investors exited India following signs of increasing trouble in India's economy. The persistent problem of the twin deficits – current account and government deficits - has been part of the reasons that investors abandoned rupee-denominated assets. For instance, portfolio investments in India shrank by US$1.6 billion in 3Q2011 compared with a US$2.5 billion increment in the preceding quarter. In contrast, in 2010 portfolio investments rose by an average US$9.5 billion per quarter due to investors' optimism about the prospects of the economy. Equity and investment fund shares also contracted by US$1.7 billion in the 3Q2011 after rising by an average US$7.6 billion per quarter in 2010 while debt securities investment dropped to US$0.13 billion from an average US$1.9 billion per quarter in the same period.

Chart 16: Portfolio investments (US$ mil)



Source: CEIC, MARC Economic Research

Chart 17: Direct investments (US$ mil)



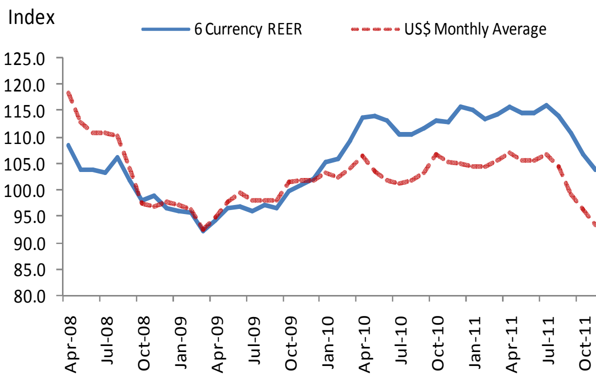
Sources: CEIC, MARC Economic Research

Long term inflows of direct investment also languished in recent years after reaching the peak of US$43 billion in 2008. By 2009, the amount of net FDI fell to US$35.6 billion and by 2010, it dropped further to US$24 billion as investors were lured to invest in other BRIC countries.

Due to massive outflows of capital, the INR was seriously battered towards the end of 2011. For the whole of 2011, the INR depreciated by 15.8% against the US Dollar following unfavourable macroeconomic factors arising from (1) prospects of slower economic growth (2) expectation of accommodative monetary measures by the RBI to avert a sharp deceleration in GDP growth (3) high inflation which dented consumer spending and most of all; (4) twin deficits in the current account and government financial position. The INR underperformed all BRIC country currencies in 2011 (Brazil -11%, Russia -5.4%, China +4.7%), declining to an all-time low of INR 53.6 against the greenback in mid-December.

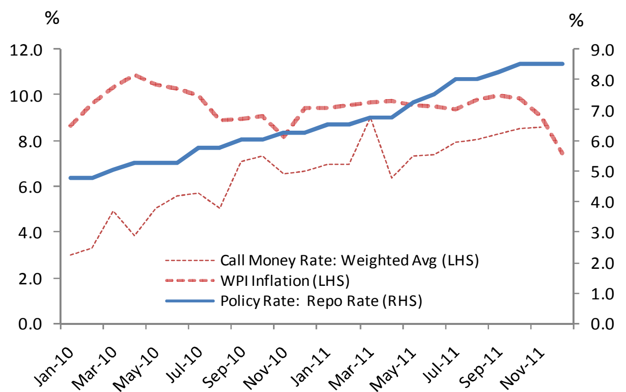
Going forward, the INR is not expected to recover drastically as the economy is facing strong headwinds from the Euro debt crisis, leading to speculation over imminent rate cuts by the RBI from the current level of 8.5%. The pessimism about the INR also stems from the fact that monetary policy maneuvering is difficult as inflation remains stubbornly high while on the fiscal side, expansionary policy is constrained by high central and consolidated government deficits (at 4.7% and 7.7% of GDP respectively in 2010).

Chart 18: INR 6-currency REER and US$ monthly average exchange rate (2009-2010=100)



Source: CEIC, MARC Economic Research

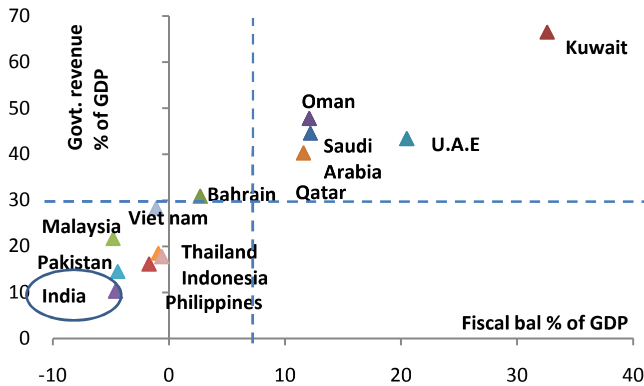
Chart 19: Policy rate, call money rate and WPI



Sources: ADB, MARC Economic Research

Comparison of five-year median macroeconomic matrices

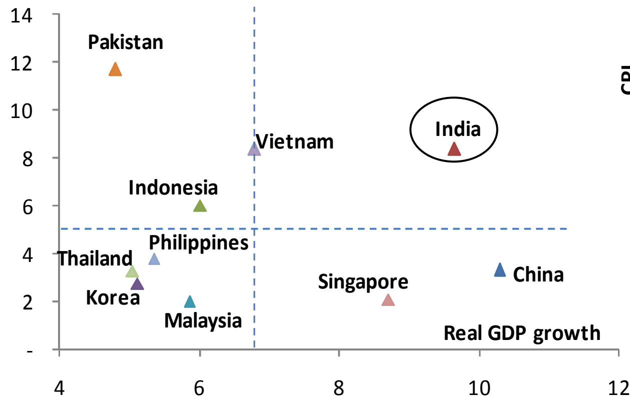
Chart 20: Government revenue vs. Fiscal balance



Sources: IMF & MARC Economic Research

- Although India had made much headway in containing government deficits, these efforts were partially derailed by the Great Recession and a very low level of taxation relative to GDP, in comparison with other selected regional economies.
- There are grounds for optimism however, as government spending as a percentage of GDP is also comparatively on the low side and revenue growth has also been very strong in recent years, driven partly by high nominal growth rates.

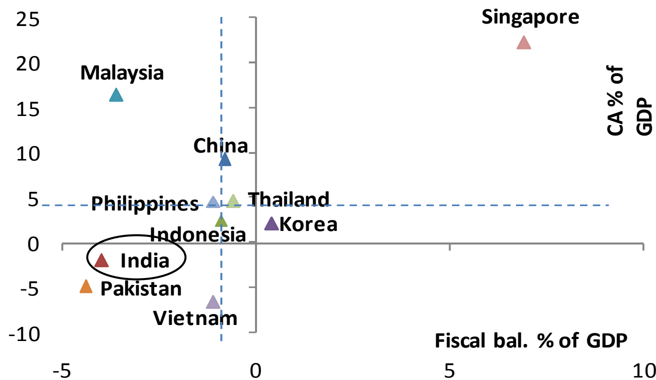
Chart 21: CPI & GDP growth



Sources: IMF & MARC Economic Research

- The economy is characterised by higher inflation when compared with the regional economies. Its CPI growth is among the highest when compared with the region's 5-year average of its median. China and Singapore are in the best quadrant as their strong economic growths were accompanied by relatively low inflationary pressure.
- India's high inflation rate was driven by both supply and demand factors. Unfavourable weather and inefficient distribution channels caused supply bottlenecks. In addition, rising wages in the past one decade has also contributed to the demand-pull inflation in the economy.

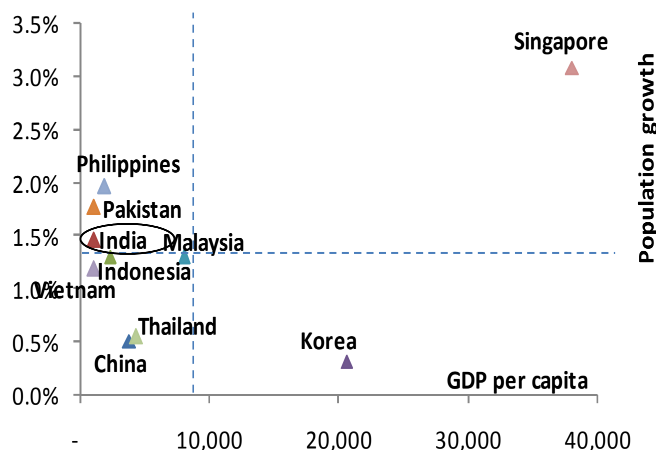
Chart 22: Current account % of GDP vs. fiscal balance % of GDP



Sources: IMF & MARC Economic Research

- India's fiscal position is relatively unfavourable with the budget gap being among the largest when compared with the region's 5-year average of its median.
- In addition, the current account balance has been persistently in deficit as oil imports continued to rise in recent years. This has led to a problem dubbed as 'twin deficits', a combination of fiscal and current account deficits. Such a phenomenon which is unique to India (among emerging economies) has caused foreign investors to flee rupee-denominated assets in recent times, resulting in a sharp depreciation of INR in 2011.

Chart 23: Population growth vs. GDP per capita

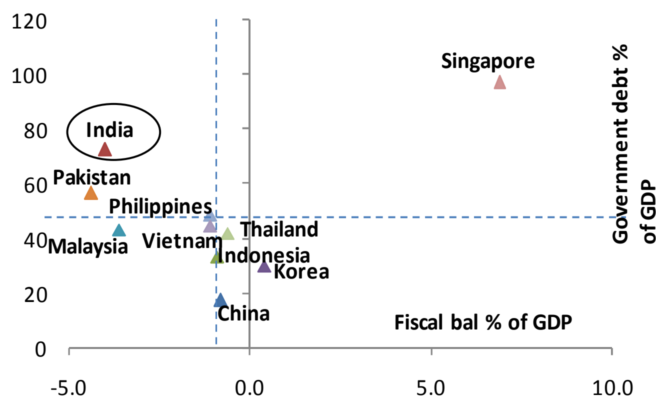


Sources: IMF & MARC Economic Research

- The country's per capita income is significantly lower than the region's 5-year average of its median (US$1,032) while its population growth is at par with the South and East Asian regions standard of 1.5%. Strong economic growth in the past two decades however has led to increasing per capita income as reflected in the per capita GNP which surged to INR 61,000 in 2010 from a mere INR 5,300 in 1990.

- The government's key agenda continues to focus on poverty reduction as well as distributional issues as income distribution may be deteriorating, common in emerging market "take-off" growth scenarios. According to the World Bank, India's Gini coefficient stands at 0.378 in 2005, which while better than the world average still indicates considerable income inequality.

Chart 24: Govt. debt % of GDP vs. fiscal balance % of GDP

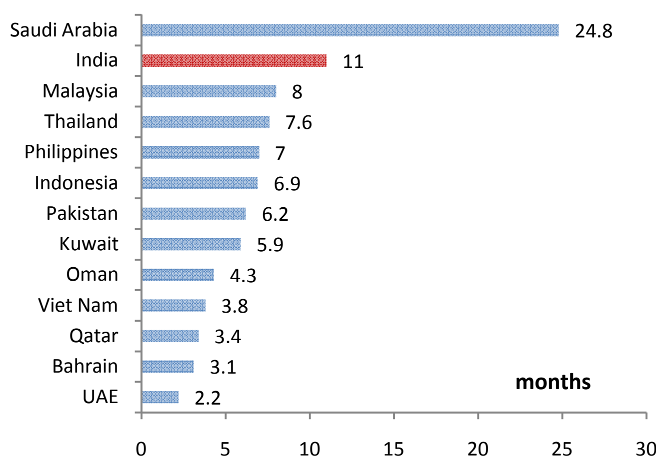


Sources: IMF & MARC Economic Research

- India's government debt as a percentage to GDP is among the highest compared to selected Asian countries. The ratio hit its peak in 2003 but has persistently declined since then. The improvement in India's debt position has to a large extent explained by high economic growth which enabled the government to collect more revenue relative to its debt level.

- In a matrix that combines the government debt versus fiscal balance, India is in the least favourable quadrant, with relatively high government debt and large budget deficits. Notwithstanding this, a persistent downtrend in the debt position and persistent efforts to reduce budget deficits will likely move India to a more favourable quadrant in the medium term.

Chart 25: Reserve-to-import ratio in months (5-year median)



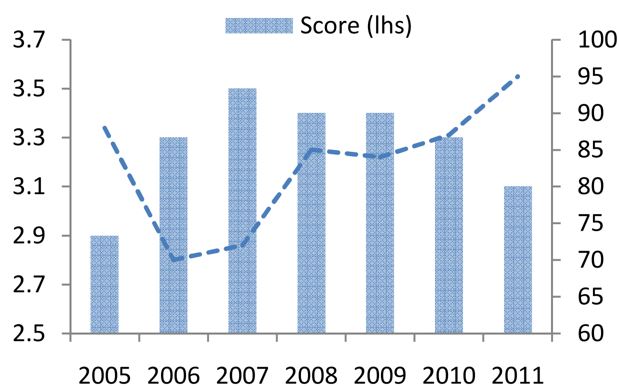
Sources: IMF & MARC Economic Research

- India's external position is somewhat favourable compared with the region's standard. Its reserve-to-import ratio of about 11 months is among the highest in the Asian region.

- India's heavy reliance on oil imports however is a major concern as the country will likely experience persistent trade deficits if global oil prices remain strong.

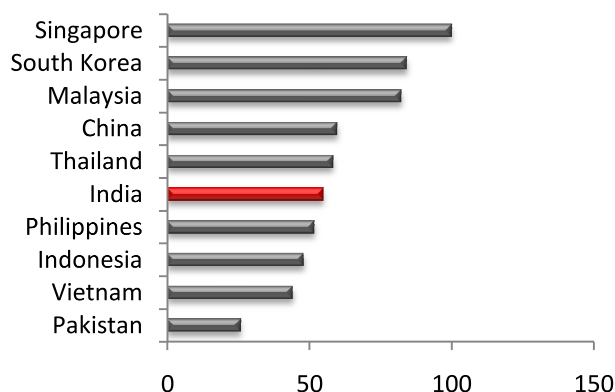
- At the same time, international reserves are heavily related to capital inflows which tend to be volatile. Recent sharp reversals in capital inflows may take a toll on the reserve position as foreign investors have started to pull back from rupee-denominated assets in light of India's increasing macroeconomic imbalances.

Chart 26: Corruption Perception Index (India)



Source: Transparency International

Chart 27: World Governance Indicators (Control of Corruption)



Source: World Bank

India's corruption statistics remain unfavourable, although it has improved from its level in 2005. Based on the Corruption Perception Index by Transparency International, the overall perception on corruption in India deteriorated in 2011 to 3.1 points from 3.3 points in the preceding year. The country's ranking in 2011 remained unfavourable at 95th position out of 182 countries compared with 87th position out of 178 countries in 2010.

Summary of Matrices

Table 4:

Government revenue vs fiscal balance	In the least favourable quadrant with high budget deficit and low revenue collection. However, tax revenue growth has been increasingly rapidly in recent years.
Government debt vs fiscal balance	In the least favourable quadrant compared with Asian countries due to the relatively high government debt and large budget deficits.
Current account vs fiscal balance	In the least favourable quadrant with relatively high budget deficits and low current account balance as a ratio to GDP.
GDP growth vs CPI	In the relatively favourable quadrant due to high average growth in the past several years. However, India's high economic growth has been accompanied by high inflation.
Percapita GDP vs population growth	Per capita GDP is relatively low but is rising rapidly due to strong economic growth. Its population growth remains average among Asian countries.
Reserve-to-import	Favourable position as India's reserve-to-import ratio is among the highest when compared with other Asian countries.
Government effectiveness	Relatively unfavourable position as the corruption index has been declining over the years. It also ranked relatively low in the government effectiveness measure.

Appendix

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
National account						
Growth (%)						
GDP	**9.5%**	**9.6%**	**9.3%**	**6.8%**	**8.0%**	**8.5%**
Supply side						
Agriculture, forestry & fishing	5.1%	4.2%	5.8%	-0.1%	0.4%	6.6%
Mining & quarrying	1.3%	7.5%	3.7%	1.3%	6.9%	5.8%
Manufacturing	10.1%	14.3%	10.3%	4.2%	8.8%	8.3%
Construction	12.8%	10.3%	10.7%	5.4%	7.0%	8.1%
Services	10.8%	10.1%	10.2%	10.0%	9.9%	9.3%
Demand side						
Total final consumption expenditure	8.6%	7.6%	9.3%	8.2%	8.7%	8.0%
-Private final consumption expenditure	8.5%	8.3%	9.3%	7.7%	7.3%	8.6%
-Government final consumption expenditure	8.9%	3.7%	9.5%	10.7%	16.4%	4.8%
Gross fixed capital formation	16.2%	13.8%	16.2%	1.5%	7.3%	8.6%
Exports	25.8%	20.0%	5.9%	14.4%	-5.5%	17.9%
Imports	32.5%	21.3%	10.2%	22.7%	-1.8%	9.2%
Public finance (% of GDP) - Centre						
Total receipts	**9.7%**	**10.3%**	**11.7%**	**9.8%**	**9.3%**	**10.5%**
-Tax revenue	7.3%	8.2%	8.8%	7.9%	7.0%	7.3%
-Non tax revenue	2.1%	1.9%	2.1%	1.7%	1.8%	2.8%
Total expenditure	**13.7%**	**13.6%**	**14.3%**	**15.8%**	**15.6%**	**15.2%**
-Non plan	9.9%	9.6%	10.2%	10.9%	11.0%	10.4%
-Plan	3.8%	4.0%	4.1%	4.9%	4.6%	4.8%
Fiscal deficit	**-4.0%**	**-3.3%**	**-2.5%**	**-6.0%**	**-6.4%**	**-4.7%**
Inflation rate						
Wholesale Price Index (WPI)	4.4%	6.6%	4.7%	8.1%	3.9%	9.6%
Consumer Price Index (CPI)	4.2%	6.8%	6.2%	9.1%	12.3%	10.5%
Money, banking and policy rates						
M1 growth	27.2%	17.1%	19.4%	9.0%	18.2%	9.8%
M2 growth	27.0%	17.0%	19.3%	8.9%	18.2%	9.8%
M3 growth	21.1%	21.7%	21.4%	19.3%	16.8%	16.0%
Bank credit growth (Scheduled commercial banks)	31.1%	28.5%	22.8%	19.3%	17.1%	21.9%
loan-to-deposit ratio (Scheduled commecial banks)	72.0%	74.5%	74.2%	72.3%	72.0%	75.8%
Gross non performing asset (NPA) ratio (SCB)	3.5%	2.7%	2.4%	2.4%	2.5%	2.4%
Repurchase agreement (REPO) rate	6.50%	7.75%	7.75%	5.00%	5.00%	6.75%
Reverse REPO rate	5.50%	6.00%	6.00%	3.50%	3.50%	5.75%
Cash Reserve Ratio (CRR)	5.00%	6.00%	7.50%	5.00%	5.75%	6.00%
Balance of payment (% of GDP)						
Current account	-1.2%	-1.0%	-1.3%	-2.3%	-2.7%	-2.7%
Capital account	3.0%	4.7%	8.6%	0.5%	3.7%	3.6%
Overall balance	1.8%	3.8%	7.4%	-1.7%	1.0%	0.8%
International reserve (USD bn)	151.6	199.2	309.7	252.0	279.1	305.5
Reserve-to-import (x)	11.6	12.5	14.4	9.8	11.1	9.6
External debt - US$ bn	139.1	172.4	224.4	224.5	261.0	306.4
External debt - % of GDP	16.8%	17.5%	18.0%	20.5%	18.0%	17.4%
Debt service ratio (%)	10.1	4.7	4.8	4.4	5.5	4.2
Development indicators						
Population (in bn)	1.1	1.1	1.2	1.2	1.2	1.2
Population (growth)	1.4%	1.4%	1.4%	1.4%	1.4%	1.4%
	1990	2000	2005	2009	2010	2011
Human Development Index (HDI) - medium high dev.	0.410	0.461	0.504	0.535	0.542	0.547

Source: Reserve Bank of India, India Central Statistics Office (CSO), Ministry of Finance (India), IMF & UNDP

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