

India's Past and Future Economic Growth



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India's Past and Future Economic Growth

Present

India's economic growth slowed to just 5.3% in the fourth quarter of 2008; a shock to many who have been accustomed to annual growth rates of 8 to 9% in the recent past. Not so long ago, in November 2008, during the meeting of the Delhi chapter of the World Economic Forum, one chief executive after another spoke at the podium arguing that India could avoid the worst of the global financial crisis. Many posited that India is less dependent on exports and the domestic banking sector has been, by and large, untouched by the toxic assets that have resulted in the global credit turmoil. Furthermore, the growth story of India has been domestic demand driven and therefore should not be affected by the collapse in consumer demand in the US and Europe. Hence, the impact from the global crisis, if any, could be expected to be relatively mild.

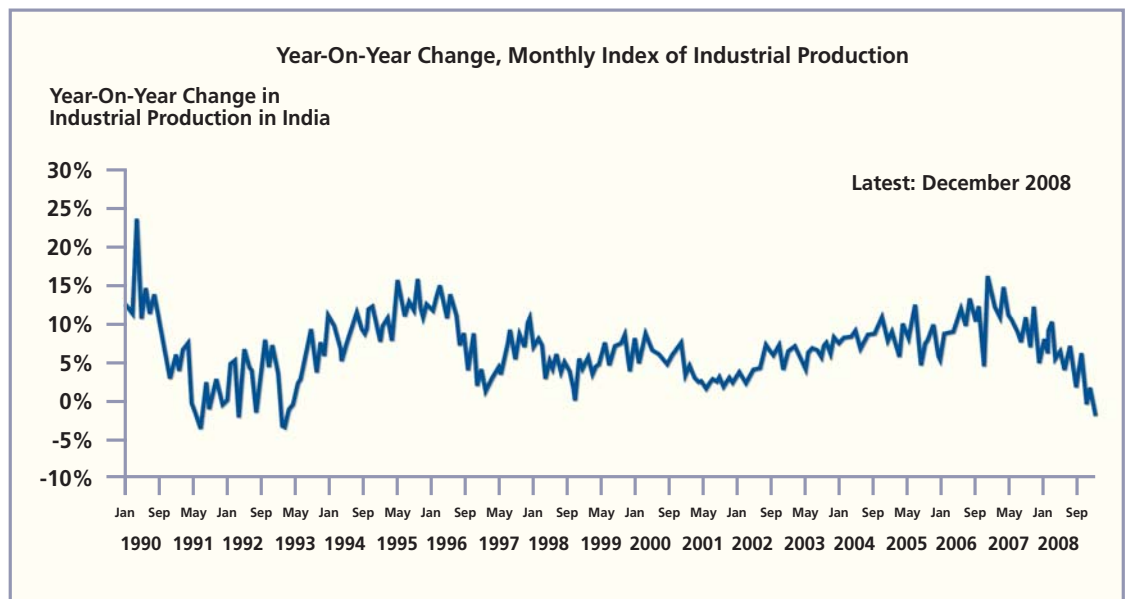
These observations are all valid; and yet the impact of the global crisis has hit India. Chart 1 illustrates the precipitous decline in India's industrial production; the year-on-year growth rates that started to slow in January 2008 plunged sharply into negative territory in the third quarter that year. It is now declining at its fastest rate since 1993.

Alarm bells are now ringing and the old complacency has all but evaporated. Calls are made for the government to increase fiscal expenditure to boost economic growth. The government has tried to comply; first with the announcement of a US\$5 billion package of new spending, and subsequently with the introduction of tax reductions for both businesses and consumers. But the reality is that the government's fiscal power is limited. Delhi has unfortunately pursued a pro-cyclical fiscal policy in recent years; providing massive fuel and consumption subsidies and forgiving farmers' loans during 2006 to 2007, a time of rapid economic growth. Budget deficits shot up.



To counter the effects of the global economic slowdown and spur economic growth, the government has announced tax cuts for businesses and citizens along with a US\$5 billion spending package.

Chart 1. Sharp Decline in Industrial Production



Source: CEIC.

Today, the government deficit (central and state level combined) is over 11% of GDP; shackling the government's ability for more aggressive fiscal spending.

In addition, this is an election year in India. Local politics will certainly dominate debates in the next few months leading up to the election in May. As happened in the past, coherent and cool-headed discourse on macro policies and structural reform will be sidelined at the local level. As the largest democracy in the world is gearing up for its election, with politicians reaching out to some 715 million eligible voters on a variety of political platforms and causes, the need for developing an effective and coordinated policy response to slowing economic growth could get sidelined.¹

The one public institution that has responded to the deteriorating economic conditions is the Reserve Bank of India (RBI). The RBI has been impressively vigilant in keeping inflation in check; especially when inflation increased in the 2007-2008 period. The RBI raised interest

rates steadily to keep inflation under control. With inflation turning to deflation in 2008, the RBI has been cutting interest rates in response. Its key policy rate has been cut by 350 basis points just in the past three months; and with inflation still falling, more rate cuts are likely to happen. Given the domestic orientation of the economy, RBI's rate cuts should be relatively effective in providing much-needed relief.

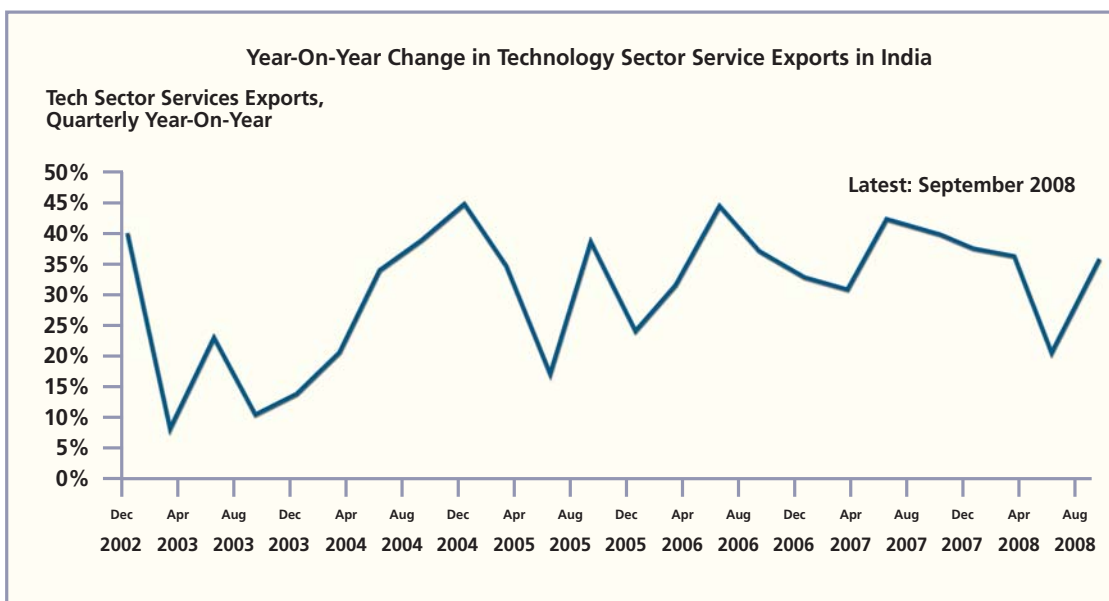
Adding to the gloom is the dimming outlook of India's brightest economic star, the IT and business outsourcing sector. Accounting for over 25% of total exports, the IT outsourcing sector has been growing at around 30% a year for almost a decade, as shown in Chart 2.

Yet, there is now rising concern that its growth will also be impacted by the global crisis. According to the National Association of Software Services Companies (NASSCOM), the sector's growth for the year ending in March 2009 is likely to be around 17%, compared with 21% in the previous fiscal year. For the coming fiscal year of 2009-2010, growth is



The one public institution that has been responsive when economic conditions began to deteriorate is the Reserve Bank of India (RBI). The RBI has been impressively vigilant in keeping inflation in check—especially during the inflationary period of 2007-2008.

Chart 2. Robust Growth of Service Exports— Until Now



Source: CEIC, technology sector exports refer specifically to Software Services Exports.



Despite all the current gloomy economic news, the outlook for India's economy is positive. In fact, in the post-crisis global economy, India will be well positioned to enjoy significant competitive advantages.

expected to decline further, and may fall as low as into single-digit territory.²

In spite of this litany of gloomy news, this report argues that the outlook for the Indian economy is positive. In fact, India is set to enjoy a new level of competitive advantage in the post-crisis global economy. Before we describe this future, however, it is necessary to examine the recent past to understand what is behind the current slowdown in growth.

Past

An important though often neglected aspect of India's strong economic growth in the recent past is that it is broadly based, encompassing not only the IT outsourcing sector; but domestic manufacturing and the agriculture sectors as well. It was this broadly based growth that gave the economy a new dynamism; reviving business investment, which in turn generated more employment and income in both urban and rural sectors. A virtuous cycle kicked in, pushing growth rates higher each year since 2004-2005.

While the global credit melee did not directly hit India; the glut of easy money did offer corporate India a new source of overseas borrowing to fund their domestic investments and international acquisitions. As Table 1 shows, total overseas borrowing by India's corporate sector in fiscal 2007-2008 was a massive US\$42 billion (with loans typically denomi-

nated in US dollars). The global credit crisis meant the drying up of this source of credit. The impact was both sudden and severe. During the period of March to September 2008, the overseas borrowing by corporate India has seen a sharp 55.4% decline year-on-year.

Compounding the difficulty is a dramatic reversal of portfolio investment flow, as shown in Table 2. During the fiscal year of 2007-2008, it is estimated that close to US\$30 billion flowed into India's equity market.³ Then the flow reversed. During the March to September 2008 period, some US\$9.2 billion flowed out of the equity market and out of the country. On a year-on-year basis, this represents a shocking drop of 145.7%. The plunge in the Mumbai Sensex then further squeezed the ability of Indian corporate to raise new capital. The net result has been an abrupt slowdown in business investment, leading to weaker income and employment creation; and subsequently consumer spending.

Hence, in spite of the domestic orientation of India's economy, the impact of the global credit crisis hit India via the channel of capital flow. As illustrated in Chart 3, portfolio flow turned abruptly negative as early as February 2008. Net capital flow then turned negative in the April/May period. India's low dependency on exports was not an adequate buffer against the global credit crisis.

Table 1. Corporate Overseas Borrowing

Total Overseas Borrowing by the Corporate Sector in Fiscal 2007 / 2008	US\$42 Billion
Year-on-Year Change from March-September 2007 to March-September 2008	-55.4%

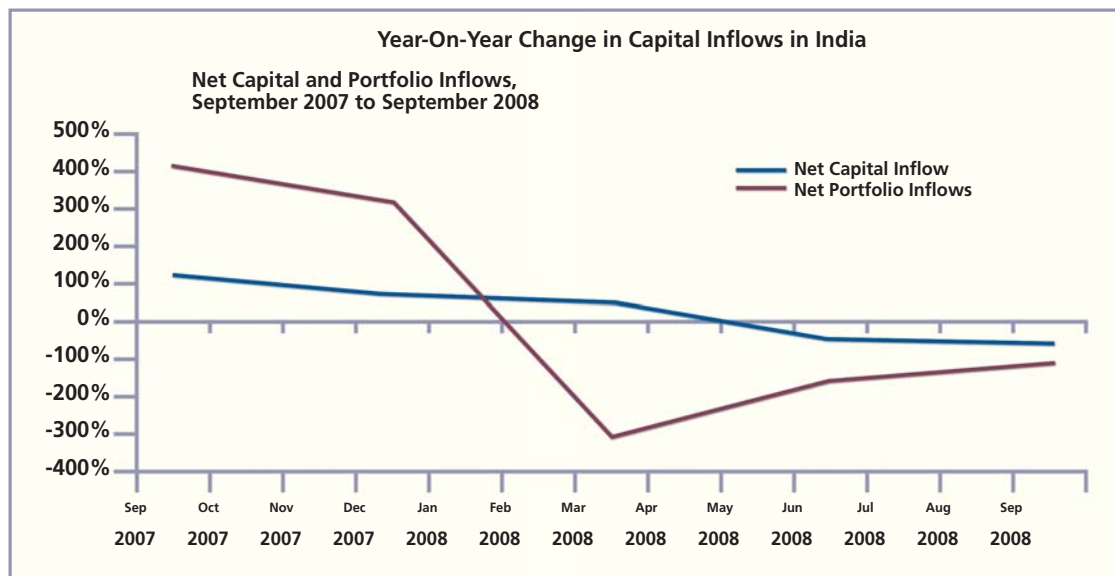
Source: RBI

Table 2. Portfolio Investment

Fiscal 2007/2008 Inflow	US\$29.4 Billion
March-September 2008 Outflow	US\$9.2 Billion
Year-on-Year Change from March-September 2007 to March-September 2008	-145.7%

Source: RBI

Chart 3. Reversal of Capital Inflow



Source: CEIC.



An important aspect of India’s strong growth in recent years has been its broad-based economy—powered by both its traditional domestic manufacturing and agriculture sectors as well as its mighty IT and outsourcing sectors.

This reversal of capital flow has, as Table 3 shows, led to a deepening of the current account deficit. The deficit rose from US\$17 billion at the end of the fiscal 2007-2008 to almost US\$24 billion during the March to September 2008 period; a massive year-on-year increase of over 253%.

An immediate consequence is the weakening of the rupee exchange rate against the US dollar. As Chart 4 illustrates, the rupee reached a peak in value against the US dollar around March 2008, then it started to slide for the remainder of the year; reaching a new low in

February 2009. Given the large overseas borrowing (in US dollars) by India’s corporate sector in the recent past, the debt servicing burden has clearly increased. With the Mumbai Sensex plunging, the market values of India’s listed companies, including the best of them, have been hammered. The situation had turned quite dramatically from one of easy and cheap credit to expensive and difficult to get (even no) credit in the course of the second half of 2008. It is therefore not surprising that many business investment projects have faltered, causing the economy to slow—unexpectedly and seemingly suddenly.

Table 3. Deepening Current Account Deficit

Fiscal 2007/2008	US\$17.0 Billion
March - September 2008	US\$23.9 Billion
Year-on-Year change from March - September 2007 to March - September 2008	+253.2%

Source: CEIC

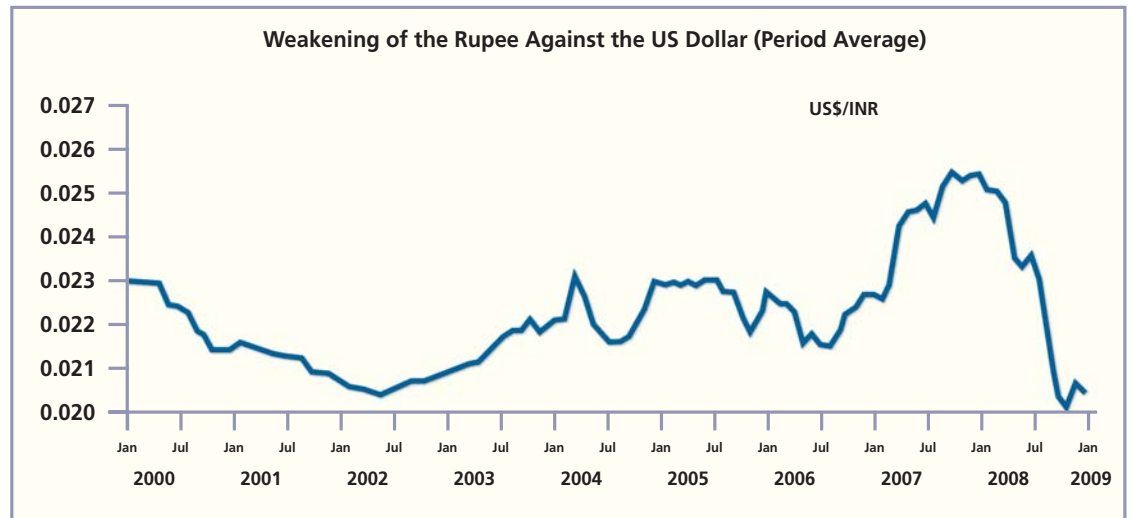
In the real economy, manufacturing was particularly hard hit. Take the textile industry for example. The textile industry is the second largest employer in India after agriculture, accounting for the employment of some 50 million workers; contributing 9% of GDP in 2007. Business investment had been brisk in this sector in recent years; with industry leaders aiming to compete with China in the global market. Many new projects were launched, both to increase production capacity and to



The rapid expansion of labor-intensive light manufacturing industries like textiles were a major source of new jobs and income for millions in the 1990s.

However, the global economic crisis has both reduced the availability of credit and diminished exports to Europe and North America.

Chart 4. Weakening Currency



Source: CEIC

improve quality. Just as in the case of China in the early 1990s, the rapid expansion of a labor-intensive light manufacturing industry like textiles has been a major source of new jobs and income for millions of poorly-educated workers in India.

However, the global credit crisis simultaneously impacted this industry in two ways. The first was a drop in its exports to the US and European markets. The second has been the drying up of credit, including the funding of working capital.⁴ Most of the businesses in this industry are relatively small operators, and that means typically that they end up at the back of the queue when it comes to getting new loans from banks. It is estimated that in the second half of 2008 about 700,000 workers had been laid off. According to industry sources, another half-million jobs will likely be lost in the first half of 2009.⁵

The tough times are by no means limited to the textile industry. SMEs in general are feeling the squeeze as well. A recent survey⁶ of SMEs in industrial production shows that 72% of them experienced a decline in their domestic orders in the fourth quarter of 2008. Over half,

58%, voluntarily cut prices in the third quarter of 2008 in order to keep their customers. However, cutting prices or not, 81% saw their margins decline over the same period. As a result, about 35% of them reduced their head count in the fourth quarter of 2008. Among those involved in exports, almost half, 46%; experienced declining orders from overseas. Overall, exactly half of the SMEs expected that orders would continue to shrink in the first quarter in 2009.

The global credit crisis is impacting India in other indirect ways as well. For example, remittances by Indian workers overseas, especially those in the Gulf Council Countries (GCC) in the Middle East, have been declining. It is estimated some US\$6 billion in remittances were sent home by Gulf-based expatriate Indian workers in 2007. The impact of this particular channel is highly concentrated in the state of Kerala; which contributes half of the 5 million expatriate Indian workers in the GCC; and their remittances amounted to twice the state government budget in recent years. As the

global credit crisis hit the GCC region toward the end of 2008 and the construction sector slowed down there, many of these expatriate workers are being sent home. The Kerala Manpower Exporters Association has estimated at least a half-million workers will be forced to return to India in 2009.⁷ The financial impact of the loss of such remittances in a state like Kerala can be expected to be serious.

This brief review of some of the key factors behind the slowing of growth in India clearly suggests that the country's low dependence on exports provides no refuge from the global credit crisis. The fact of the matter is that India's strong economic growth in recent years has been broad-based, encompassing sectors as diverse as IT and outsourcing, manufacturing and agriculture. Rising business investment had been the prime mover in lifting growth rates. Thus, the economy as a whole had benefited from easier access to cheap credit in one way or another, directly or indirectly. After all, capital is highly fungible in today's global market, and there is no reason why it should be different in India.

The current difficulties, however, are not portents of a premature end to the Indian growth story. On the contrary, India is set to recover faster and stronger than many other markets; returning to higher growth in the order of 6 - 8% in real GDP as early as fiscal 2009/2010. Furthermore, a new dynamic in the post-crisis global economy will further enhance India's competitive advantage in the coming years.

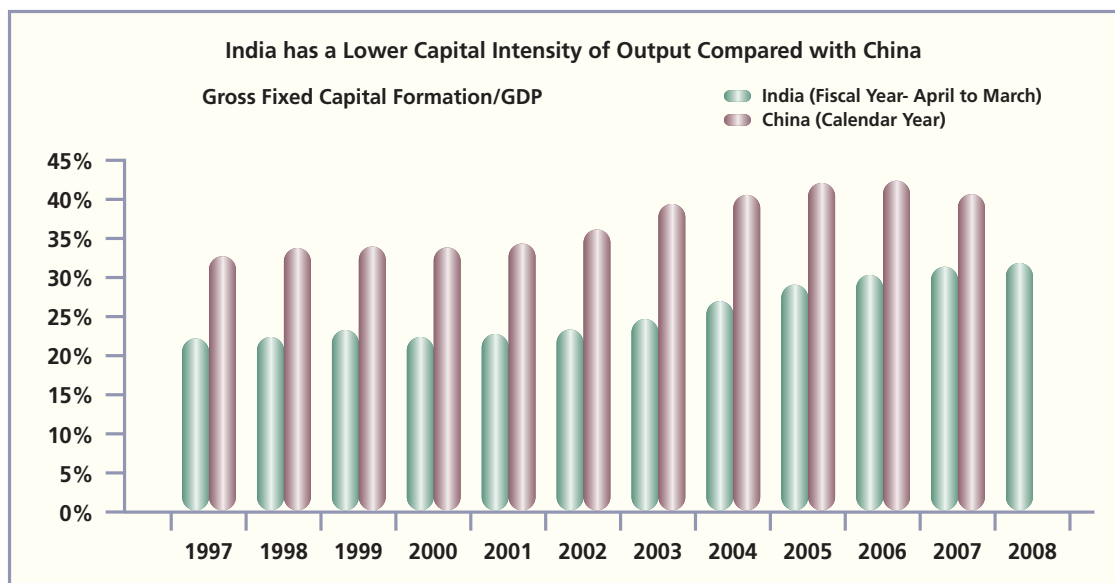
Future

India could recover faster than many other markets because it has always been less capital intensive in its development. For decades under the so called "License Raj," when industrial production was tightly regulated, investment funding (including the precious "hard currency," the US dollar) was directed by the government's five-year plans. State-owned companies and those in strategic sectors had priority to investment funds, leaving private businesses fighting for the leftovers. Conse-



The global credit crisis is affecting India even in an indirect manner. For example, construction has slowed in Gulf Council Countries (GCC) and many construction workers from India are being sent home. It is estimated that, in 2007, remittances sent home by Gulf-based expatriate Indian workers totaled US\$6 billion.

Chart 5. Capital Intensity of Output Compared: India and China



Source: CEIC



Nimble, capital-efficient businesses and quality investments will help India's economy in navigating out of the current economic slowdown. India's leading sector, IT outsourcing, will also be in an enviable position— because the post-crisis world economy will face an overcapacity in manufacturing but an undersupply in high-end services.

quently they learned how to do more with less. Even after the reform in the early 1990s that largely dismantled the License Raj; Indian businesses continued to be very investment capital efficient. Chart 5 compares the investment-output ratio between India and China over the 1997 to 2007 period. China's investment-output ratio is consistently a quarter to a third higher than that of India's.

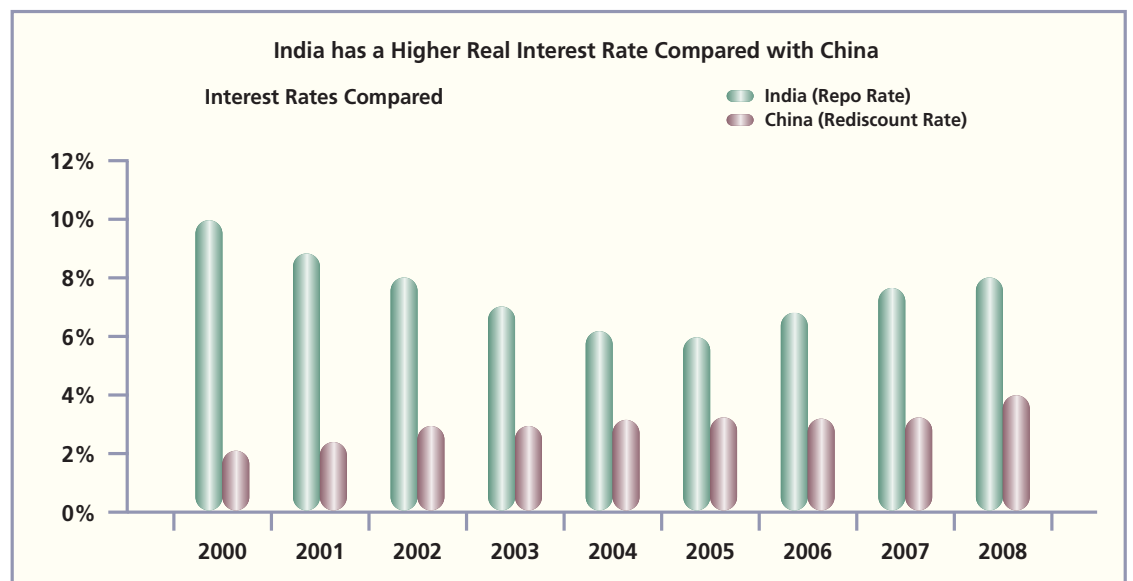
One of the reasons for China's higher invest-output ratio has to do with China's massive investment in infrastructure and urban facilities that has been sustained for over a decade. However, it is also the case that Chinese companies, especially the state-owned enterprises (SOEs) that have preferential access to bank loans, have tended to invest heavily in capacity expansion and technology upgrades in recent years. Their growth has turned out to be extraordinarily capital-intensive given China's per capita income level. In contrast, Indian businesses have retained a relatively lighter touch when it comes to deploying investment capital. This in turn means that Indian businesses can operate more effectively under today's condition of credit squeeze.

Consequently they will be able to move faster when recovery begins.

Another factor that could help India to recover faster is its better quality of investments. Because the RBI has been vigilant in controlling inflation; and the setting of commercial interest rates in India is more market driven; real interest rates in India as a result are more consistent with market conditions of demand and supply. As seen in Chart 6, the policy rate has been higher in India than in China through the entire period of 2000 to 2008. From the perspective of investment quality, this means that the "hurdle rate" for justifying an investment has been higher in India than in China. Everything else being equal, it can be expected that the quality of investments will be better in India than in China.

Nimble and capital efficient businesses combined with better-quality investments will enable the Indian economy to navigate more effectively out of the current economic slowdown. Once the recovery begins, however, India's leading sector, IT outsourcing, will also

Chart 6. Interest Rates Compared: India and China



Source: CEIC

Table 4. Global Over-Capacity in Manufacturing

December 2008	Global Capacity	Global Production	Capacity Utilization
Automobiles (Millions Per Year)	90	66	73%
Semi-Conductors (Wafers Per Month)	14,900	9,200	62%

Sources: Automobiles - CSM Worldwide; Semi-conductors - I Suppli.

be in an enviable position to enjoy unprecedented competitive advantages. This is because the post-crisis global economy will be saddled with massive over-capacity in manufacturing while suffering from supply constraints in high-end services. Table 4 shows clearly, in the two examples of auto and semiconductor manufacturing, the extent of excess capacity as of December last year. Through the course of 2009 such overcapacity is likely to get a lot worse.

In addition to overcapacity, manufacturing producers outside of China will also be in the

unenviable position of having to compete with China.⁸ China's labor market has shown to be extremely flexible. In spite of the stricter new labor code which includes minimum wage provisions, wages are coming down as exports decline. Many migrant workers are reported to have been able to find jobs after the Lunar New Year holiday, but at lower wages. Local governments have been encouraging employers to negotiate wages with workers to get the best deals they can. The dreaded "China price" is set to return with a vengeance. According to US government statistics, US imports from



Businesses in India have retained a relatively lighter touch in deploying investment capital. As a result, they can operate successfully in a credit squeeze. And they will be nicely positioned when the recovery begins.

Table 5. Price Signals: Capacity Constraints in Services versus Over-Capacity in Manufacturing

		Price Change: December 2007 to December 2008
Manufacturing and Commodities	Gasoline	-43.1%
	TV	-19.4%
	Toys	-18.2%
	Automobiles	-6.8%
Services	Management and Technical Consulting Services	+1.7%
	Legal Services	+5.2%
	Computer Consulting Services	+5.3%
	Health Care Services	+5.4%
	College Tuition	+5.8%

Sources: Manufacturing and Commodities: Standard & Poor's; Services: Bureau of Labor Statistics



In the post-crisis global environment, India's IT outsourcing sector will shine brightly. If the government follows through with reforms and addresses infrastructure deficits, economic growth in post-crisis India should easily outperform their achievements of recent years.

China fell 0.7% in January 2009, the fifth consecutive month of decline. This trend is set to continue for the foreseeable future.⁹

Table 5 shows the sharp contrast in price movement between manufacturing and commodity products on the one hand, and services on the other in the US in 2008, a year of deepening recession. Prices declined across the board from gasoline to TV to toys to automobiles. And yet in high-end services such as management consulting, legal, computer consulting, health care and education; prices rose. The only explanation for price increases under conditions of rising unemployment, plunging consumer confidence, shrinking business investment, and rising household savings; which all became evident in 2008, is that there are severe supply constraints in these services.

These are high-end services that India's IT outsourcing sector are best positioned to supply. In spite of the increasingly shrill political rhetoric of protectionism, service outsourcing

will become more of a necessity than a nice-to-have option for many American businesses once they have survived the global crisis. Intense competition, as they fight for consumers' shrinking wallet; coupled with consumer demand for better value in whatever they buy; will place a hefty premium on business' ability to be more efficient and innovative. Their ability to outsource effectively will virtually be a lifeline to their continuing survival. This will be true for not only American businesses, but increasingly also for businesses in Europe and East Asia as well.

In this new post-crisis global environment, India's IT outsourcing sector will therefore shine brighter than ever before. If the government can also follow through with the much needed reform and address infrastructure deficits; then economic growth in post-crisis India could easily outperform what has been achieved in the recent past.

1. Some would argue that the Indian government's inability to conduct aggressive fiscal spending is a blessing in disguise; minimizing future market distortion and avoiding the crowding out of more productive private investment.
2. J. Fontanella-Khan, "India's outsourcing growth seen to slow down," Financial Times, February 5, 2009.
3. Much of it came from the Yen carry trade.
4. Up until mid-2008, rising prices of imports such as fuel and raw materials had also increased the costs of production for this industry.

5. J. Fontanella-Khan, "Indian textile industry feels the crunch," November 22, 2008. Financial Times.
6. CLSA India SME Pulse, January 2009. This survey covers SMEs involved in industrial production, including those in auto ancillaries and engineering.
7. Y. Trofimov, "Slowdown in Persian Gulf reaches India," March 1, 2009, The Wall Street Journal.
8. In any event, much of the manufacturing excess capacity is in China.
9. A. Wheatley, "China looks to make a fresh start," March 3, 2009, International Herald Tribune.

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